



Planning from the grave – Testamentary trusts

July 2023

Jamie Golombek

Managing Director, Tax and Estate Planning, CIBC Private Wealth

One of the main functions of your will is to name the beneficiaries who will inherit the assets that make up your estate. When choosing beneficiaries, there are many reasons why it can make sense to include trusts in your estate plan. A trust is an arrangement in which property is managed by one or more person(s) for the benefit of another person (or persons). Rather than leaving an asset directly to a beneficiary under your will, you could create a trust and name a trustee who would manage the assets on behalf of the beneficiary under terms you specify.

Trusts are frequently used for gifts or bequests to minor beneficiaries, who have not yet reached the age of majority (which is 18 or 19 years of age, depending on the province or territory of residence). Since the beneficiary cannot legally manage the funds, someone must be appointed to do this on behalf of the child until the child reaches the age of majority. When leaving an inheritance for a minor beneficiary in your will, you can specify that assets be left in trust for the benefit of a child and designate a trustee who would manage the trust funds. Generally, you can also do this outside your will by designating a trustee as a beneficiary for proceeds of life insurance and proceeds of plans, such as Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs) and Tax-Free Savings Accounts (TFSA).¹

Whether you name a trustee through your will or a beneficiary designation, this creates what is commonly known as a “testamentary trust,” a term under the *Income Tax Act* meaning that the trust arises as a consequence of your death. You can outline directly in your will, or through the beneficiary designation, the terms by which the trustee must abide, such as how trust property should be managed and when property can be distributed.²

Leaving assets in a trust, rather than naming direct beneficiaries who will receive assets outright upon your death, can help solve some common estate planning mistakes.

Mistake #1: Giving it all away at once

Kim wants to fund post-secondary education expenses for her 18-year-old son, Lee. She has earmarked \$100,000 and plans to use the funds to pay for Lee’s annual tuition and living expenses while he attends school and establishes his career. As part of her estate planning, Kim has decided she wants Lee to have these funds if she were to pass away.

Suppose Kim leaves a bequest of \$100,000 to Lee in her will. The estate administrator would pay \$100,000 to Lee and he could use the funds for his education and living expenses, as Kim intended; however, there won’t be any limits as to how Lee spends the funds. If Lee decides he’d really rather have a nice sports car, there is nothing preventing him from spending the entire \$100,000 on this purchase.

¹ In Quebec, you can only designate beneficiaries for life insurance products. Insurance proceeds that are payable to a beneficiary do not form part of the succession. Where a third person is named to administer the assets payable to a beneficiary under certain life insurance products, a personal trust is created and the administrator is considered to be the trustee.

² In Quebec, creating a testamentary trust with insurance proceeds requires a formal trust created in the will.

Rather than giving the money to Lee all at once, Kim may consider leaving the \$100,000 in the care of a trustee who would manage the funds on Lee's behalf for specified purposes. For example, the trustee could be given discretion to pay for expenses related to Lee's support and education. The trust terms could also specify an age at which the trustee would transfer any remaining funds to Lee, such as when he reaches age 30. This could delay final distribution of the funds until a time when Lee might be in a better position to make responsible financial decisions.

Mistake #2: Letting your beneficiaries' inheritances be eroded

Testamentary trusts are not necessarily only beneficial for minors. Even if you don't have any concerns about the ability of a beneficiary to be financially responsible, leaving assets in trust may help protect inheritances from claims of third parties.

When your beneficiaries inherit assets directly, the assets may become subject to certain legal claims against the beneficiary. For example, if you leave assets to a beneficiary who later goes into bankruptcy, the inherited assets may become subject to creditor claims. Also, if a beneficiary divorces, inherited assets may be subject to claims by the beneficiary's former spouse. Leaving assets in trust for your beneficiaries can sometimes protect the beneficiaries' inherited assets from these claims.

Taxes may also erode the amount that is available to beneficiaries, particularly when they pay tax at high rates. While income of most testamentary trusts is taxed at the highest personal marginal tax rate, there is an exception for a qualified disability trust (QDT). A beneficiary who is eligible for the disability tax credit (known as a "preferred beneficiary") can make a joint election with the trustee to have one testamentary trust that is treated as a QDT and will be subject to graduated tax rates. This would allow the income to be accumulated in the trust and taxed at graduated tax rates.

Of course, this area is complex, and the rules vary among the provinces and territories, so be sure to get professional legal advice when pursuing strategies in this area.

Mistake #3: Choosing the wrong trustee

Even among those who use trusts in their estate plans, many people end up simply naming a family member or friend as a trustee. A common mistake is choosing a trustee who is approximately the same age as you. As you grow old, the trustee will grow old as well. And when you eventually pass away, the trustee may be unable to act or even deceased. Choosing to involve a corporate trustee, such as CIBC Trust, can prevent this situation. Unlike a living person, a corporate trustee will exist indefinitely and can continue to serve as trustee for as long as one is needed.

Often a family member is chosen as trustee under the assumption that this is a less costly option than using a professional trustee; however, this is not necessarily the case. Any trustee, including a friend or family member, is entitled to receive compensation for providing trust services. Each province and territory has guidelines for the amount of compensation a trustee can charge.

Let's look at another example to illustrate why the choice of a trustee is so important. Suppose Robert wants to leave an inheritance for his daughter, Rachel, who is currently eight years old. Robert is divorced and doesn't want his ex-wife (who has custody of Rachel) to manage Rachel's inheritance if he were to pass away while Rachel is still a minor. Robert is considering creating a trust for Rachel under his will and naming his sister, Karen, as trustee.

Being a trustee can be a complex and time-consuming job. Karen would need to make many decisions, such as choosing appropriate investments and deciding on the amount and timing of distributions to Rachel. Physical custody and management of the assets would also be Karen's responsibility, and she would need to undertake tasks such as completing paperwork to open accounts, buying and selling assets, and making ongoing payments and withdrawals. If real estate was involved, she might also need to complete property management tasks such as paying household bills, repairs and maintenance. Karen must also ensure that proper accounting records are maintained for all trust financial activities and annual tax returns are filed for the trust. Does Karen have the necessary skills, knowledge and time to perform these tasks?

Robert would be well-advised to consult with Karen before naming her as trustee to see if she would be willing to act in this capacity. Too often, people simply assume their family and friends would be honoured to help. In truth, Karen may not want to perform this time-consuming role, particularly since it could last for ten years (until Rachel reaches age 18), or even longer. During that time, Karen would need to communicate with Robert's ex-wife, who has custody of Rachel, which could also be uncomfortable for Karen. As a trustee, Karen would also be liable for any errors in trust administration – a risk she may not want to assume. And what if Karen were to become incapacitated or die during the trust term? If Karen were unwilling or unable to perform the trustee role, then the court would appoint a new trustee if Robert had not named an alternate trustee in his will.

Naming a professional trustee can help to prevent some of these issues. CIBC Trust and its predecessors have over 100 years of experience in acting as trustee for numerous clients and can administer the trust efficiently. They have expertise dealing with legal issues, tax filings, investment decisions and discretionary payments while balancing the needs of all beneficiaries. You can appoint CIBC Trust as the trustee of a testamentary trust, either alone or as a co-trustee along with another individual.

If you have been appointed as a trustee and find yourself in need of assistance in carrying out your duties, CIBC Trust also offers "Agent for Trustee" services. This allows you to maintain decision-making authority, but delegate the burden of handling the administrative duties to CIBC Trust.

Since trust and tax laws are very complex, advice should be obtained from legal and tax professionals prior to implementing any trusts. Your CIBC advisor can provide more information about having CIBC Trust act as a trustee or about Agent for Trustee services.

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Private Wealth in Toronto.

jamie.golombek@cibc.com

This report is published by CIBC with information that is believed to be accurate at the time of publishing. CIBC and its subsidiaries and affiliates are not liable for any errors or omissions. This report is intended to provide general information and should not be construed as specific legal, lending, or tax advice. Individual circumstances and current events are critical to sound planning; anyone wishing to act on the information in this report should consult with their financial, tax and legal advisors.

The CIBC logo is a trademark of CIBC.