

TESTAMENTARY TRUSTS FOR INCOME TAX AVOIDANCE

A. Introduction

This paper is focused on how income taxes can be avoided through the use of testamentary trusts. Graduated tax rates, income splitting, designated beneficiary provisions and the preferred beneficiary elections are some of the tax avoidance measures that can be used to avoid taxes with a testamentary trust.

B. Definition of Testamentary Trust

Because we are concerned only with the income tax ramifications of a testamentary trust in this discussion, it is helpful to review *The Income Tax Act* definition.

108(1) "**Testamentary Trust**" in a taxation year means a trust or estate that arose on and as a consequence of the death of an individual (including a trust referred to in subsection 248 (9.1)), other than:

- (a) a trust created by a person other than the individual,
- (b) a trust created after November 12, 1981 if, before the end of the taxation year, property has been contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof, and
- (c) a trust created before November 13, 1981 if....[see Act for details if this comes up];

As we can see from the definition, trusts established under a Last Will and Testament and funded with assets flowing through the estate of the deceased clearly qualify as testamentary trusts. Assets can also be transferred from one testamentary trust in some circumstances and flowed into another testamentary

trust without losing the qualifying status. A testamentary trust is frequently set up for a surviving spouse on the express terms that when the surviving spouse passes away the remaining contents of the spousal trust will then be divided into a series of testamentary trusts for the children. CCRA has said in a technical interpretation that the trust would continue to qualify as a testamentary trust under those circumstances.

C. Separate Taxpayer Status

A trust is not a separate legal entity at law, but it is treated as a separate taxpayer under the *Act*. This allows for considerable tax avoidance as discussed below.

1. Graduated Rates

A testamentary trust pays tax on a graduated basis. The first \$32,183.00 of income is enjoyed at the lowest rate. The next \$32,185.00 is in the second, higher, tax bracket, the next \$40,262.00 of income on top of that is taxed in the third tax bracket, and income on top of that is taxed in the fourth tax bracket. Although a testamentary trust receives graduated tax treatment just like a flesh and blood person, it does not receive the personal income exemption.

Example of How it Works

The graduated tax rates that apply to a testamentary trust, coupled with the separate taxpayer status, allow for a broader tax base. This can be used to drive tax savings. Consider the following by way of illustration. The example assumes interest income. Different federal-provincial rates of tax apply to dividends and capital gains:

A father leaves an estate of \$800,000 to his two children, Ted and Oliver. Both children are adults and earn income in top tax brackets. The estate is divided between them, each receiving \$400,000.00. The will provides that Ted's inheritance is bequeathed to him in a trust, Oliver's is given to him outright.

Each invests the money in income producing assets. Oliver has no choice but to invest his inheritance in his own name. Ted takes his inheritance in the trust that is legally held by the trustees and beneficially owned by Ted. Each investment pool earns income at a 7% rate each year. Thus, each of the two \$400,000.00 pools generates \$28,000 in income each year. Since Oliver already is taxed at the top rate, and since the investment income is layered on top of his own income from employment and other sources, his income will be taxed at the top rate of 46%. He pays \$12,880 of the \$28,000 he earns from his inheritance to CCRA each year. Ted's trust files a return for the income earned by the trust money. The trust is entitled to its first \$30,000 in the lowest tax bracket. Thus, the \$28,000 of income in the trust will be taxed at roughly 26%. Ted's trust pays \$7,280 to CCRA each year. The tax savings realized for Ted will amount to $(\$12,880 - \$7,280) = \$5,600$ annually. This calculation rounds the tax rates and the cut off points for the tax brackets. It assumes no alternative minimum tax is payable.

The tax savings generated by the structure are a function of the spread between the lowest federal provincial marginal rates and the highest. That spread varies with the kind of income. For interest income the spread is 19.5% (46.40% - 26.90%). For dividend income on taxable dividends received by individuals from taxable Canadian corporations that spread is 24.37% (33.83% - 9.46%). For capital gains income that spread is 9.75% (23.20% - 13.45%). The tax rates above are combined Federal and

Manitoba tax rates reflecting budgets to June 30, 2001, adjusted for basic personal tax credits.

2. Multiple Trusts

Since each trust is a separate taxpayer, there will be circumstances in which one seeks to establish as many trusts as possible to try to expand the tax base. A separate trust for each beneficiary achieves that result. Each trust will file its own tax return. Each will enjoy its first \$32,183.00 of income at the lowest rates.

If, however, you try to establish multiple trusts for the same beneficiary, you may discover that Canada Customs and Revenue taxes them all as one collectivity under subsection 104(2) of the Act. Some of the circumstances that will determine the application of subsection 104(2) as follows:

- Whether or not there was a **clear** intent by the testator, as evidenced by the terms of the will, to create separate trusts;
- Whether or not the trusts had common beneficiaries;
- Whether or not the assets of each trust were segregated and accounted for separately (e.g. separate bank accounts, no undivided interests in property, separate accounting records), and
- The conduct and powers of the trustees.

With careful drafting and awareness of the issue, the application of ss. 104(2) can be avoided to provide additional tax savings generated by the creation of multiple trusts.

E. Income Splitting

Income earned in a trust is taxed on an annual basis just as it is for individual taxpayers. In order to avoid paying the taxes the whole of the income generated, dividing that income among different taxpayers achieves additional tax avoidance. The general rule is that income which remains in the trust at the end of the year is taxed at whatever rates are applicable to the trust. Income which is paid out to a beneficiary or for their benefit is taxed in the hands of the beneficiary at the end of the year. A will-maker may set up a trust for the benefit of a child but contemplate that the income beneficiaries might be “my son, his wife (if he is married), his children (if any), or any one of them, all within the discretion and within such amounts as trustees deem appropriate”. The idea is this. With a discretionary income clause that allows the trustees to “sprinkle” income among a pool of beneficiaries it allows for the income of the trust to be spent on the beneficiaries with the lowest tax rates. As far as children are concerned they have to have legitimate direct or indirect expenses to offset against the income payments. Nevertheless, since both direct and *indirect* expenses can be paid for, it doesn’t pose much difficulty to spend at least \$7,000.00 per child. The personal exemption available to each flesh and blood taxpayer is approximately \$7,500.00. Thus, if income is spent on the children, it will appear on their tax returns. If it appears on their tax returns, the first \$7,500 will be in essence tax-free.

Careful records have to be kept, including receipts for all expenditures. Expenditures for “necessaries” (food, medicine, clothes) appear to qualify. Less certain are expenditures like a share of the mortgage on the family home, but aggressive income splitting strategies will often include that. The official CCRA position is that trust expenditures can be included in a minor’s income where:

. . . it is reasonable to consider that the payment was made in respect of an expenditure for the child’s benefit; i.e. amounts paid for the support,

maintenance, care, education, enjoyment and advancement of the child, including the child's necessities of life.”

If top-bracket income earners receive inheritances outright, and invest it in their own names, every penny of income earned on those inheritances will be taxed at the top Federal Provincial Marginal Rates of Tax. If, instead, they receive their inheritances in the form of a trust, with the ability to sprinkle income, and they have children, they can realize significant annual tax savings. This is the same “family trust” which was popular on an *inter vivos* basis before the kiddie tax came in. It is still possible to drive all of the benefits that were available but now only on a testamentary basis.

Example of How It Works

Consider the following example: Ted has inherited \$400,000 in the form of a trust for his benefit. It allows for the discretionary allocation of income among Ted, any wife he may have, and his two dependent children. As in the earlier example, it is invested at a 7% rate of return. Thus, \$28,000 in income is generated on the inherited pool of investments. Ted spends \$7,000 of trust income on each child, buying their books, bicycles and groceries, and taking them on family vacations. The balance of the income is taxed in the trust. Thus, \$14,000 of income is included on the children's returns and escapes taxation under their personal exemptions. The balance is taxed in the trust at a 26% rate. The total tax sent to CCRA is approximately \$3,640.00. If Ted had inherited outright, like Oliver in the earlier example, the total tax payable is \$12,880.00. The savings amount to approximately **\$9,240 each year!**

The above analysis oversimplifies – giving the children income impairs the ability to claim the children as dependents. If a full analysis is conducted, taking all factors into account, the savings stand up with very little erosion in most cases.

F. Designated Income

Under subsections 104(13.1) and (13) of the Act, income can be paid out to an individual but a designation can be made under which the trust and the individual choose to have that income taxed in the hands of the trust rather than the hands of the individual. This can be quite useful. Imagine the following scenario.

Example of How It Works

A testator leaves \$200,000.00 in an inheritance to his daughter who is a doctor. The trust invests the inheritance in income producing assets, and it generates a 7% annual rate of return. Thus, \$14,000.00 of income is earned each year. If that income is left in the trust, it will be taxed at the lowest Federal Provincial marginal rate (currently 26% on interest income here in Manitoba). If it were paid out to the doctor, then it would be taxed at her tax rate, being roughly 46%. Using the ability of the trust to designate such income as retained by the trust, the tax rate will be roughly half that. The differential in taxes paid to CCRA in tax each year should be roughly \$2,856.00. If the size of the trust is doubled, the tax savings are doubled. This remains true until the income generated in the trust overflows the first tax bracket and spills into the second tax bracket. The designated income provisions allow the doctor to take out all of the income and spend it on high living while it is taxed in the trust at a lower rate.

There are even certain instances where the beneficiary and trustee can revisit the issue and structure a designation retroactively to a date in the past. The case *Lussier v. R.* 1999 CarswellNat 2730 (Tax Court of Canada) (attached), involved a testamentary trust that had been established for a widow. She took the income out each year for roughly a decade. Every year she declared it on her own tax return. She paid taxes at high rates on that income by virtue of a high income she enjoyed from sources other than the trust. The opportunity to designate the income as having been retained by the trust was never brought to

her attention. Finally when someone with the knowledge made her aware of the missed opportunity to do declare the income in the trust, she sought to re-file her taxes on that basis retroactively. Revenue Canada tried to cap that effort, saying that the *Act* only allowed her to go back for a prescribed number of years. On the strict wording of the *Act*, however, the Federal court held that she could re-file on a retroactively back to the origin of the trust, well beyond the time frame allowed by CCRA.

G. Preferred Beneficiary Election

In common with *inter vivos* trusts, preferred beneficiary elections can be filed in connection with a testamentary trust. The beneficiary has to be profoundly disabled, as the preferred beneficiary election has been limited to fairly extreme cases of mental or physical impairment. Nevertheless, when those situations occur, the preferred beneficiary election can be powerful from a wealth accumulation perspective. The preferred beneficiary election provides for a joint election that allows income to be left in the trust and accumulated while it is taxed on the beneficiary's tax return [104(14)]. The income is deducted from the trust tax return [104(12)].

While the income re-accumulates in the trust, and is taxed on the return of the beneficiary, in whole or in part, two beneficial tax results can occur. First, the personal exemption of the disabled beneficiary can be fully used up allowing roughly \$7,500.00 of tax free income to be enjoyed each year. Second, if the income of the trust was sufficiently large, up to \$60,000.00 could be retained in the trust while the balance could be allocated equally to the two tax returns, with \$30,000 on the return of the disabled beneficiary and the remaining \$30,000 on the tax return of the trust. *Leaving the income in the trust can, with proper drafting, leave the disabled beneficiary in a position to receive continued government support.*

H. Flow Through Income

The trust can have various kinds of income. It might, for example, have capital gains income, interest income, and dividend income all in the same year. It is possible to flow through certain kinds of income to the beneficiaries in the form it was earned by the trust. If the testamentary trust has capital gains income, that capital gains income can be flowed through to the beneficiaries, and be characterized as such on their income tax returns. Thus, the capital gains can be allocated to the beneficiary who receives the best tax treatment. It does not appear to be a requirement that an even hand be used in that regard, and you can pick and choose among the various beneficiaries so long as the trust expressly allows for it. The same is true of interest or dividend income.

Deductions for capital cost allowance and terminal losses in respect of depreciable property owned by a trust may be claimed by the trust, or may instead be claimed by the beneficiaries on their income tax returns on a flow through basis.

I. Conclusion

Outlined above are some of the strategies for tax avoidance through the use of testamentary trusts. Testamentary trusts when drafted by skilled and experienced practitioners and advisors can be used to take advantage of graduated tax rates, to split income, allow for designated income in the trust and for the preferred beneficiary election.

J. Information in this Paper not Substitute for Legal Advice

This paper is intended as an introduction to this topic. It is not a substitute for specific legal advice tailored to a client's particular needs. Any person wishing advice on how to order their affairs, or those of a client, should contact a member of our Wealth and Succession Practice Group. This paper is also largely based on the laws of Manitoba, and while laws are similar from Province to Province, the content of this paper may not be accurate in other provinces.

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