

SPOUSAL TRUSTS

Contrary to what many people believe, trusts are not only for the wealthy. In fact, trusts, and especially testamentary trusts, are an important estate planning tool for a broad range of individuals and can save on taxes and provide peace of mind.

This Reference Guide discusses testamentary trusts in general and focuses on a specific form of testamentary trust, the *spousal trust*.

WHAT IS A TRUST?

A “trust” is an obligation that binds a person (the “trustee”) to deal with certain property (the “trust property”), which the trustee controls, for the benefit of specified persons (the “beneficiaries”). To create a trust, a person, referred to as a “settlor”, transfers legal ownership of property to the trustee(s) and provides instructions to the trustee(s) regarding how the property is to be used for the benefit of the beneficiaries. This arrangement can be made either in a trust agreement (in the case of a lifetime or inter vivos trust) or in a Will (in the case of a testamentary trust). A testamentary trust can, in some circumstances, also be created in other documents that take effect on an individual’s death.

A testamentary trust is a trust that arises on and as a consequence of an individual’s death, so it only becomes effective on the death of the person making the Will (the “testator”). Most often, a testamentary trust is created with funds or assets from the estate, but it can also be funded with life insurance proceeds.

An example of a testamentary trust is where a testator’s Will states that some or all of the estate is to be held and invested by a trustee to be used to provide for the benefit and support of the testator’s spouse. This is known as a “spousal trust”.

Note that if a spousal trust may have trustees or beneficiaries resident in Quebec, please refer to our Reference Guide on Spousal Trusts in Quebec.

THE SPOUSAL TRUST

A spousal trust is a form of testamentary trust typically created in a person’s Will to provide for a surviving spouse. To qualify as a spousal trust for income tax purposes, the spousal trust must meet the following criteria:

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- ❖ The surviving spouse must be entitled to receive all the income of the trust during his or her lifetime; and
- ❖ No person other than the surviving spouse can receive, use, or have the benefit of the capital of the trust during the surviving spouse's lifetime.

Note that the tax laws applicable to spouses also apply to common-law partners. In general, opposite sex and same sex partners are considered to be common-law partners for tax purposes after a period of 12 months cohabitation.¹ Accordingly, all references to a "spouse" in this Reference Guide apply equally to a common-law partner.

The Spousal Rollover

The use of a spousal trust offers the opportunity to defer taxes through the spousal rollover.

Generally, on death, a person is considered to have disposed of all of his or her capital property at the fair market value of the property. This deemed disposition may result in the realization of taxable capital gains. However, where the assets are transferred to a surviving spouse or to a qualifying spousal trust, the tax on capital gains is deferred until the death of the beneficiary spouse.²

Generally, the spousal rollover will apply to transfers of property to a spousal trust if *all* of the following requirements are met:

- ❖ The deceased spouse was resident in Canada immediately before his or her death;
- ❖ The spousal trust was resident in Canada immediately after the property was transferred to it; and
- ❖ The property vests indefeasibly in the spousal trust within 36 months after the deceased spouse's death. An extension of this vesting period may be granted by the Minister of National Revenue within the 36-month period.

¹ Note that this definition applies only for income tax purposes. Each province and territory also has its own laws governing the rights of common-law partners for other purposes, such as property sharing on the breakdown of the relationship or on death.

² Different rules apply for registered plans. To have a registered plan transfer on a tax-deferred basis to the spouse's plan at death, the proceeds of the registered plan must be designated directly to the spouse as beneficiary (rather than to a trust). Alternatively, the estate must be designated to receive the proceeds and the spouse must be a beneficiary of the estate or named in the Will as beneficiary of the plan proceeds. The executor and spouse must then file an appropriate election under the *Income Tax Act* to have the plan benefits "rolled" to the surviving spouse's plan.

Property that passes to a testamentary trust that does *not* meet all of the requirements of a spousal trust will *not* be eligible for the rollover. Instead, the usual rules will apply, so that the property will be deemed to have been disposed of at its fair market value immediately prior to the death of the first spouse, with any resulting gains being taxed in the deceased spouse's final tax return.

WHAT ARE THE BENEFITS OF A SPOUSAL TRUST?

The benefits of using a spousal trust can be summarized as follows:

1. **Reducing the income tax that the spouse will pay** on the future income earned on his or her inheritance;
2. **Helping to protect the spouse's inheritance** from claims from his or her present and future creditors, and possibly from marital or family property claims;
3. **Ensuring that the testator's wishes and intentions will be respected** regarding the use of the inheritance and who ultimately receives the property.

Each of these is discussed in detail below.

Reducing Income Tax

If a surviving spouse inherits assets *directly* on the death of his or her spouse, the income produced by those assets would be added to the surviving spouse's other income, so that most or all of the additional income may be subject to the highest rate of tax. However, using a spousal trust will allow for a reduction in the total taxes payable. This is because under the *Income Tax Act*, a testamentary trust, including a spousal trust, pays tax at the same graduated marginal tax rates that apply to individuals. As a result, if assets are held in a spousal trust (rather than left directly to the surviving spouse), the income produced by the assets would be considered income of the *trust*, rather than income of the spouse, with the trust paying tax on that income at graduated marginal tax rates. Subject to the terms of the Will or trust, if the trustees file the appropriate elections, even income that is actually paid out to the spouse may be taxed as if it were the trust's income.

The tax savings can be significant. If the surviving spouse is taxed at the highest marginal rate on his or her other income, and if the spousal trust established in the Will earns enough income to use up the lowest marginal tax bracket (for example, if the spousal trust earns approximately \$35,000 per year), the spousal trust can save the surviving spouse between \$4,500 and \$8,600 each year, depending on the province.

It should be noted that there are some ongoing expenses involved in maintaining a trust. Generally, the greatest expenses are for the preparation of the annual

tax returns for the trust and for documenting the various decisions of the trustees (such as decisions regarding capital encroachments, etc.). Fees may also be charged by the trustees.

We generally recommend that a spousal trust be created only if it will likely hold assets of at least \$300,000. In this way the trust can generate enough income to make the tax savings worthwhile.

An attractive feature of a spousal trust from a tax perspective is that the usual rule that a trust is deemed to dispose of all its capital property every 21 years, with any resulting capital gains tax payable at that time, does *not* apply. As a result, the taxes on capital gains are deferred until:

- the trust disposes of a capital asset, or
- the trust transfers the property to the beneficiary spouse and he or she disposes of it, or
- the beneficiary spouse dies.

Caution regarding Improper Property Transfers and Loans

To ensure that a testamentary trust, including a spousal trust, continues to maintain its tax-advantaged status, it is very important to ensure that other individuals do not add property to an existing testamentary trust. If there is an improper transfer of property to a testamentary trust, the trust ceases to be a testamentary trust and is, from then on, considered to be an *inter vivos* trust. This means that *all* of the income of the trust would be taxed at the *highest* marginal tax rate, rather than based on graduated marginal tax rates.

Pursuant to draft amendments to the tax legislation put forward in February 2004, the same adverse consequences could also arise if a beneficiary of a testamentary trust (or certain other individuals connected to the beneficiary) makes loans or advances funds to the trust in certain circumstances. These amendments, which would be effective for trust taxation years after December 20, 2002, are intended to prevent inappropriate income splitting using testamentary trusts.

Caution re Surviving Spouse becoming Resident Outside of Canada

Care should be taken if the surviving spouse is or may become resident outside of Canada while he or she is a beneficiary under a spousal trust.

There is generally no Canadian tax advantage to having a Canadian trust for a person resident outside Canada. In some jurisdictions, there may be tax advantages for the beneficiary under the tax regime applicable to the beneficiary,

while in other jurisdictions, there may be adverse tax consequences for the beneficiary.

These potential issues should be explored with the appropriate tax advisors in planning a spousal trust if there is a possibility that a surviving spouse may become resident outside Canada.

Helping to Protect the Spouse's Inheritance from Creditors' Claims

The use of a properly drafted spousal trust can help to provide some protection from creditors if there is a concern that a spouse has or may have debts or liabilities.

For example, the spousal trust can include specific instructions regarding matters such as who is to manage the assets of the trust, to ensure that the trustees control the assets, and not the beneficiary spouse alone.

In addition, if the intention is to allow the spouse to have access to some or all of the capital of the trust, this could be limited or subject to appropriate restrictions. Alternatively, the trustees could be given complete discretion regarding payments of capital, so that they could distribute the capital in a way that would truly benefit the beneficiary spouse, or subject to appropriate considerations.

In this way, the creditors of the spouse may not be able to access the funds or property held in the trust, so the inheritance may be protected from the spouse's creditors (and/or the spouse's spending habits). It should be noted, however, that if the trust is to be a qualifying spousal trust for tax purposes, in order to take advantage of the spousal rollover referred to above, then the surviving spouse must still be entitled to all of the income from the trust during his or her lifetime.

The use of a spousal trust may also help to protect assets from future marital or family property claims in the event the surviving spouse remarries or begins a common-law relationship and the marriage or common-law relationship ends. It should be noted, however, that as a result of several recent court cases, this protection may not be quite as certain as in the case of protection from creditors. Nevertheless, establishing a spousal trust for a surviving spouse would still provide the opportunity for more protection than leaving assets outright to a surviving spouse.

Ensuring that the Testator's Wishes and Intentions will be Respected

Testamentary trusts are very flexible tools that offer a testator the ability to exercise significant control over how property left on death is to be used, including which heirs are to benefit and when. Ideally this ability can be used to guide beneficiaries, minimize family disputes and maximize the benefit of the beneficiaries' legacy. The following is a summary of some of the ways spousal trusts can be used to achieve these goals:

Protecting the Children of a Previous Marriage or Protecting Children from the Loss of their Inheritance if the Surviving Spouse Marries or Becomes involved in a Common-law Relationship

Testators typically want to provide properly for their surviving spouses, but sometimes are concerned that their children may be disinherited if the assets are left directly to the surviving spouse. This often arises where there are children of a previous marriage or if there is a concern that a surviving spouse may marry or become involved in a common-law relationship.

A spousal trust may help to address some of these concerns. For example, if appropriate restrictions are placed on distributions of capital from the spousal trust, the testator can be reasonably assured that his or her children will receive the unused capital of the trust when the beneficiary spouse dies. However, in these circumstances, it would be very important to consider whether establishing a spousal trust would satisfy the testator's obligations to the surviving spouse under family law. As noted below, the preparation of a Spousal Agreement (or a comparable agreement for common-law partners, if applicable) would be recommended in which both spouses acknowledge the establishment of the spousal trust and waive their rights to an equal division of property when the testator dies.

Business Assets

A testator may wish to ensure that his or her surviving spouse benefits from the testator's business interests (such as shares in a family business), but may prefer that the business be managed by another individual, such as a child who is intended to take over the business. Transferring the shares to a spousal trust will permit the spouse to derive income from the business while someone else manages it. Using a spousal trust in this way may facilitate the succession of the business to the next generation, who could ultimately receive the business interests from the spousal trust after the death of the surviving spouse.

PLANNING A SPOUSAL TRUST

In addition to meeting the qualifying requirements for a spousal trust outlined earlier, there are a number of other important matters that must be considered when planning and establishing a spousal trust.

Beneficiaries of the Spousal Trust

While the surviving spouse is alive, he or she must be the only beneficiary of the spousal trust. As noted earlier, for tax purposes, this means that the spouse must be entitled to all of the income of the spousal trust, and no one other than the spouse can benefit in any way from the capital of the trust so long as the spouse is alive. The Will can, however, specify other beneficiaries of the assets of the spousal trust once the beneficiary spouse has died.

Selecting Trustees for the Spousal Trust

The trustees of the spousal trust play an important role, as they are responsible for the management and investment of the assets of the trust, for filing the annual tax returns, and for making decisions regarding payments of income and capital to the beneficiary spouse.

Unless otherwise specified in the Will, the executors of the estate would also be the trustees of the spousal trust, which may not always be the most suitable choice. It may therefore be desirable to name separate trustees for the spousal trust. Alternate trustees for the spousal trust should also be named in the Will, in case one or more of the primary trustees should die, resign, or be unwilling or unable to act or continue to act.

Some of the factors to consider in selecting appropriate trustees and alternate trustees include:

- ❖ *Validity of the Trust:* While naming the beneficiary spouse as one of the trustees is possible, it is generally recommended that he or she should not be the only trustee or the controlling trustee of the spousal trust. If the beneficiary spouse is to be a trustee, at least one other co-trustee (such as a trusted relative or friend) should be named to act together with the spouse in order to ensure the validity of the trust for trust law and tax purposes.
- ❖ *Ability and Willingness to act:* Given the responsibilities involved, the trustees selected should have the appropriate skills and knowledge to be able to act effectively in handling all aspects of the trust, or should at least be aware that they could (and should) retain professional assistance when needed. The trustees should also understand the nature and extent of their role and be willing and able to act over many years, since a spousal trust continues for the lifetime of the beneficiary spouse.
- ❖ *Potential conflict of interest:* Naming a child or children as trustees could give rise to possible conflict of interest concerns if the child or children are to benefit once the beneficiary spouse has died. For example, the children may refuse to allow payments of capital to the beneficiary spouse, since such payments would reduce their ultimate inheritance, or they may choose long-term investments that benefit their own interests, to the detriment of the beneficiary spouse, who may need investments that produce higher current income.
- ❖ *General Suitability:* Given the extent and potential duration of the trustees' responsibilities, there should be no concerns about the trustees' ability to deal with the spouse or other intended beneficiaries or about the level of control and involvement that the trustees would have regarding the management and administration of the trust and its assets.

- ❖ *Maintaining Trust Assets:* Appointing a beneficiary spouse as a trustee and giving him or her the discretion to make payments of capital from the spousal trust may give rise to concerns that the spouse will leave little or no assets remaining in the trust. While this may be appropriate in some circumstances, this can be a concern where one of the purposes of the spousal trust is to protect the assets of the deceased spouse for the benefit of other beneficiaries once the beneficiary spouse has died. Some options to address this potential concern include:
 - not naming the beneficiary spouse as a trustee;
 - appointing an independent party as a co-trustee, and giving this trustee the decision-making authority regarding investments and capital payments out of the trust; and/or
 - not allowing capital payments out of the trust, or restricting the ability to make capital payments to only limited circumstances.
- ❖ *Residence of the Trust:* For tax purposes, a trust is generally considered to be resident where the trustee who manages or controls the assets of the trust resides. This is always a question of fact involving a consideration of numerous factors. As noted earlier, a spousal trust must be resident in Canada in order to qualify for the spousal rollover. Even if the spousal rollover is not important, if a spousal trust is considered resident in a country other than Canada, there would be considerable tax complexities for the trust and its beneficiaries. For this reason, it would be desirable to ensure that the spousal trust is resident in Canada for tax purposes by ensuring that a majority of the controlling trustees are resident in Canada while the trust is in effect. This could also help to minimize practical difficulties that could arise if one or more trustees are not physically present in Canada.

Objectives of the Spousal Trust

It would be valuable for the trustees if the Will establishing a spousal trust included a clear indication of the testator's primary intentions for the trust. This would help the trustees in making decisions regarding matters such as the investment of trust assets and encroachments on the capital of the trust.

For example, if the primary purpose of the trust is to benefit the surviving spouse, without regard to the interests of children or others who may benefit once the surviving spouse has died, the trustees would then know that they should focus on the interests of the spouse only. As a result, they could make investments that maximize income for the benefit of the spouse and they would be able to decide more easily about paying out capital to the spouse (assuming that encroachments are permitted).

On the other hand, if the testator wishes to provide for a surviving spouse during his or her lifetime, but wants to maximize capital for children or others once the spouse has died, then this would guide the trustees when making investment and encroachment decisions while the surviving spouse is alive.

Without specific guidance in the Will, the trustees must *balance* the respective interests of the surviving spouse and the ultimate beneficiaries of the trust. This means that the trustees would have to take a balanced approach with the investments, to ensure that the assets provide both income (for the benefit of the spouse) and capital growth (for the benefit of the ultimate beneficiaries of the capital of the trust). Similarly, decisions to encroach on capital would have to be made by considering not just the spouse's need or request for funds but also the impact that such an encroachment would have on the capital beneficiaries. If this is acceptable, then no special provisions would be needed in the Will, although it would be helpful to the trustees if this intention was clearly spelled out.

Another guideline that could be incorporated in the Will is whether the spousal trust is to be considered to be a primary source of support for a surviving spouse or whether the spouse is to be expected to use his or her own resources, with the capital in the spousal trust to be available only as a supplementary source of funds.

Payments of Income and Capital

As noted earlier, the spousal trust must provide that the surviving spouse is entitled to all of the income from the spousal trust during his or her lifetime.

If desired, the Will could provide for the spouse to receive at least a minimum amount each year, using funds out of the capital of the trust, to ensure that the spouse will be protected if the income is low in any given year. This might be particularly important if the spousal trust is expected to be a primary means of support for the surviving spouse.

In addition, depending on the testator's intentions, the Will could give the trustees of the spousal trust full or limited power to pay capital to the spouse, either in the trustees' discretion or under certain conditions (but to no one else while the surviving spouse is still alive).

Note that if the trustees are given full discretion to provide as much of the capital of the spousal trust to the spouse as they consider advisable (that is, an unlimited ability to encroach on the capital), the trustees (including the spouse, if named as a trustee) could then pay any amount of the capital to the spouse as required or desired. They could even decide to terminate the trust. Accordingly, such broad discretion should be included only if this is consistent with the intent and objectives of the spousal trust.

Note also that for tax purposes, capital gains are generally treated as *income*. Under trust law, however, capital gains are considered to be *capital*, so that the trustees could only distribute these to capital beneficiaries of the trust. If desired, however, the trust document (which would typically be the Will in the case of a spousal trust) can define what is to constitute *income* of the trust for trust purposes. Accordingly, depending on the particular objectives of the spousal trust, the income of the trust could be defined to include capital gains. This would make the treatment of these amounts the same for both trust and tax purposes and could also facilitate desired distributions to the spouse.

NEED FOR A SPOUSAL AGREEMENT OR COMMON-LAW PARTNER AGREEMENT

Under family law legislation, spouses generally have a right to an equal division of family property on divorce. The same rights may apply on the death of a spouse. In addition, in some provinces, these same rights also apply to common-law partners.

It is possible that providing the surviving spouse (or common-law partner) with an interest in a trust (which is difficult to value) may be insufficient to strictly fulfill the legal obligation to the spouse (or common-law partner) under family law. Accordingly, if a spousal trust is to be established in a Will, it is recommended that the spouses (or common-law partner) enter into a Spousal Agreement (or a comparable agreement for common-law partners, if applicable), in which they each acknowledge the establishment of the spousal trust and waive their respective rights to an equal division of family property on the death of either of them.³ Where the parties both see the benefit and value offered by spousal trusts, often a fairly simple agreement is sufficient to deal with this issue. Each of the spouses should, however, obtain independent legal advice prior to finalizing any such agreement.

SUMMARY

Spousal trusts can offer considerable benefits, such as tax savings, creditor protection, and other estate planning opportunities. If any of these are of interest, the benefits could be explored further with an advisor who is knowledgeable about spousal trusts and family law.

³ The rules regarding marital and family property division on the termination of a marriage or common-law relationship and at death, and the rules regarding spousal and other domestic agreements, vary across Canada, as each province and territory has its own legislation on family law. It is therefore recommended that the advice of professional legal advisors be obtained regarding the laws in the applicable province or territory.