

Testamentary Spousal Trusts

A testamentary spousal trust can be used to provide support for a surviving spouse or common-law partner for the remainder of their lifetime and subsequently pass on any remaining assets to capital beneficiaries such as a charity or children of the deceased individual who established the trust. For the purposes of this article, references to a spouse also include a common-law partner.

What is a Testamentary Spousal Trust?

A testamentary spousal trust (or a testamentary common-law partner trust) is a special trust under the *Income Tax Act Canada* (ITA) that is established under a testator's Will for the benefit of the surviving spouse. A properly structured testamentary spousal trust can defer the tax consequences that may otherwise arise from the deemed disposition of capital properties upon the testator's death and provide certain other benefits.

What are the Prerequisites for Tax Deferral?

The requirements set out in the ITA for a testamentary spousal trust to qualify for tax deferral are as follows:

1. The transfer of property occurs as a consequence of the taxpayer's death to a trust created under the taxpayer's Will.
2. The deceased taxpayer is resident in Canada immediately before death.
3. The testamentary spousal trust is resident in Canada immediately after the time the property "vests indefeasibly" in the trust. Generally, property vests indefeasibly when absolute and unconditional ownership is acquired.
4. The surviving spouse is entitled to receive all of the income earned by the testamentary spousal trust during their lifetime. No other person is entitled to receive or otherwise obtain the use of any of the income or capital of the trust during the surviving spouse's lifetime. However, while the surviving spouse is entitled to all of the trust income during their lifetime, restrictions can be imposed on the capital distributions to the surviving spouse.

A testamentary spousal trust is a trust with its own unique features and benefits which can be established for the benefit of the surviving spouse of a testator by the provisions in the testator's Will. This structure makes it possible to defer the tax consequences that may otherwise arise from the deemed disposition of capital properties upon the testator's death.

Note: Beware of inadvertently "tainting" a testamentary spousal trust by allowing someone other than the surviving spouse to benefit from it during the spouse's lifetime. For example, if the trust

Testamentary Spousal Trusts

provides that it will terminate on the remarriage of the surviving spouse, or if it provides that a child may also benefit during the lifetime of the surviving spouse, it will then not qualify as a testamentary spousal trust and, in turn, it will not qualify for tax deferral.

5. The property vests indefeasibly in the testamentary spousal trust within 36 months of the taxpayer's death.

Tax Treatment of Testamentary Spousal Trusts

A testamentary spousal trust is treated as a separate taxpayer. Where income earned in the testamentary spousal trust is retained in the trust, it is subject to income tax at top combined federal and provincial tax rates. If the testamentary spousal trust is considered a qualified disability trust (QDT), it may enjoy graduated tax rates.

What are the Advantages of Using a Testamentary Spousal Trust?

One of the main advantages of using a testamentary spousal trust is that it enables the testator to provide for a spouse during their lifetime and preserve the capital of the assets for other beneficiaries. In addition, there are several benefits in using a testamentary spousal trust:

Tax Deferral

- The transfer of property to a trust will normally trigger a disposition of the property at fair market value. However, one option would be to transfer property to a qualifying testamentary spousal trust on a tax-deferred basis. As a result, tax may be deferred until the surviving spouse's death or disposition of the property.
- Typically every 21 years a trust is deemed to have disposed all of its capital properties thereby triggering any accrued capital gains. This rule does not apply to testamentary spousal trusts during the lifetime of the surviving spouse. If the testamentary spousal trust continues after the death of the surviving spouse, this rule will apply 21 years after the date of death of the surviving spouse (and every 21 years thereafter). This could further defer the realization of accrued capital gains.

Professional Management

The testator may have concerns that the surviving spouse, who may not have the necessary financial acumen, may mismanage assets upon the death of the testator. Using a testamentary spousal trust, where a corporate trustee is appointed, can ensure that the funds are professionally managed. Upon the death of the surviving spouse, the capital can then be distributed to other beneficiaries, such as the testator's children. This can provide the testator with peace of mind.

Second Marriage Concerns

Example

Alex and Morgan are planning to get married. Both have previously been married and have children from their previous relationships. Alex would like to ensure that, in case she dies first, Morgan will benefit from the income generated from her assets, but that the assets will eventually go to her own children from the first marriage. Upon Morgan's death, Morgan would like to ensure a similar result in case he dies first. How can this be achieved?

Often, in marital situations, “mirror Wills” are utilized. For example, both spouses may indicate in their Wills that upon one spouse’s death, all the assets will go to the surviving spouse. There may also be provisions regarding alternate beneficiaries in case the spouse who is the intended beneficiary predeceases the testator or if both spouses die in a common disaster.

However, a mirror Will may not be appropriate in the scenario involving Alex and Morgan above. Assuming Alex dies first, if her Will provides for the assets to be given to Morgan outright, the assets will form part of Morgan’s estate and when Morgan dies these assets will likely end up in the hands of Morgan’s own children rather than Alex’s children from the first marriage.

What Alex could consider is setting up a testamentary spousal trust in her Will. With the testamentary spousal trust, her assets can be held in trust for Morgan’s lifetime. All income from the trust assets will be paid to support Morgan. Normally, the trustee will also be given discretion with respect to the encroachment of the capital of the trust. On Morgan’s death, the remaining assets of the testamentary spousal trust will be paid out to Alex’s children from the first marriage as per the trust provisions. In essence, with the testamentary spousal trust, Alex has satisfied both of her estate planning needs: support for Morgan’s lifetime, as well as an inheritance to her own children from the first marriage.

A testamentary spousal trust could also be set up in Morgan’s Will. Consequently, if Morgan dies first, the assets can be held in trust for Alex’s lifetime and when Alex dies, the remaining assets of the testamentary spousal trust will be paid out to Morgan’s children from the first marriage.

Please note that provincial legislation may impact this type of arrangement. We encourage you to discuss all options and intentions with your legal advisors prior to implementing any planning.

When is a Testamentary Spousal Trust Not Appropriate?

Testamentary trusts are not appropriate in all circumstances. For example, when intergenerational business succession planning is a priority, a testamentary spousal trust may not be an appropriate planning tool.

Example

Pat (age 75) has successfully developed a business which is now worth ten million dollars. Pat was divorced twice and is currently married to Darcy (age 60). Pat has three adult children from previous marriages. These children are not on speaking terms with Darcy. Pat loves the children and wants the business to ultimately go to them. However, Pat also wants to ensure that Darcy, who has rather expensive tastes, is well-provided for after Pat dies.

In this situation, a qualifying testamentary spousal trust will provide a tax deferral upon Pat’s death and also ensure that the business will eventually be transferred to the children. However, the children will not inherit the business until Darcy’s death. The fact that the children are not on good terms with Darcy can result in constant feuding and potentially cause problems in the efficient running of the business. Moreover, as the ultimate capital beneficiaries, the children will prefer to reinvest the earnings of the business to keep it growing. This will conflict with Darcy’s high income requirements. There is a real risk of disruption to the business, so it may be advisable to forego the potential tax advantages of the testamentary spousal trust and look for other solutions in order to ensure a smooth transition of the business.

Other Considerations

Legal, Accounting and Trust Administration Fees

Setting up a testamentary spousal trust will inevitably involve initial fees as well as ongoing annual fees and expenses in order to maintain the trust structure. It is imperative that a cost-benefit analysis be done by your tax and legal advisors to help ensure that the testamentary spousal trust structure reflects your estate planning goals and is a viable option for you.



The information contained herein has been provided by TD Wealth and is for information purposes only. The information has been drawn from sources believed to be reliable. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. TD Wealth represents the products and services offered by TD Waterhouse Canada Inc., TD Waterhouse Private Investment Counsel Inc., TD Wealth Private Banking (offered by The Toronto-Dominion Bank) and TD Wealth Private Trust (offered by The Canada Trust Company). All trademarks are the property of their respective owners. © The TD logo and other trade-marks are the property of The Toronto-Dominion Bank.

Revised 05/08/2019