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Wills And Estate Planning: A Primer (YLD)

The Use of Trusts In A Will

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THE USE OF TRUSTS IN A WILL

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A properly drafted Will is usually the cornerstone of a good estate plan. A good estate plan will address a wide variety of planning considerations including whether a beneficiary should receive his or her interest in the estate by outright gift or whether the gift should be left in trust.

The decision to use one strategy or the other will be influenced by factors such as the following:

1. The personal values, wishes and objectives of the testator;
2. The age of the beneficiary;
3. The beneficiary's ability to manage his or her financial affairs;
4. Whether the beneficiary is disabled;
5. The nature of assets that form the estate and the size of the proposed gift;
6. Whether the beneficiary has or will likely have creditors;
7. The marital status and the stability of the beneficiary's relationship;
8. The residence of the beneficiary, i.e. Ontario or a foreign jurisdiction;
9. The income of the beneficiary;
10. The tax implications to the estate and to the beneficiary;
11. The availability and suitability of trustees;

12. The relative cost and expense associated with one solution or the other.

This list is not exhaustive.

In many cases, the decision to leave a gift in trust will be influenced by one or more of the following planning objectives:

(a) The wish or need to control the beneficiary'suse and enjoyment of the inheritance;

(b) The testator's wish to protect the inheritance from the beneficiary or the beneficiary's creditors;

(c) Tax considerations (in the estate and for the beneficiaries);

Before giving some examples of how trusts are used in a Will, let's review some trust basics.

Some Trust Basics

It is beyond the scope of this paper to provide a detailed commentary on the law of trusts. The following is just a brief overview of some basic trust rules and the limitations on the use of trusts in a Will.

It is generally accepted that a trust is not an entity. It is a relationship. A trust relationship arises when a person, called the settlor, delivers property to a trustee and directs the trustee to hold the property for the benefit of a person or persons called beneficiaries. A trust can be created while a person is alive or it can be created to take effect after a person dies. The former type of trust is commonly referred to as an "inter vivos" or "living" trust, the latter type of trust is commonly called a "testamentary" trust. A testamentary trust is typically created in a Will. The testator is

the settlor. The executor is typically the trustee but a trustee need not be the executor. The testator's family members, such as a spouse, child or grandchildren, are typically the beneficiaries,however, any person or a charity may be a beneficiary of a trust.

In law school, we learned that a trust must have three characteristics:

(a) Certainty of intent;

(b) Certainty of subject matter;

(c) Certainty of objects.

These are commonly referred to as the three certainties. The certainty of intent is usually addressed by clear language in a Will that the testator intends to establish a trust, for example, "...I direct my trustee to hold the residue of my estate in trust..." The certainty of subject matter refers to the property that will be held in the trust, for example, "...I direct my trustee to hold the residue of my estate in trust." The certainty of objects refers to the beneficiaries. The beneficiaries can be named or may be identified by class,for example, "my children" or "my brothers."

When a trust structure is established in a Will, the trust itself does not come into existence until thetestator dies and the trust property is transferred to the trustee.

When the trust comes into existence, the trustee is expected to act according to the powers that the settlor gives to the trustee in the Will. The trustee will typically be authorized to hold and/or invest trust property until certain conditions or events are met and, until the conditions are met, the trustee may also be authorized to make mandatory or discretionary distributions of trust income or capital.

The specific powers given to the trustee will depend on the testator's planning objectives. There is no one trust structure that will apply in all cases. Each trust can be specifically designed for the particular objective and to address the unique circumstances of each individual case.

Some clients will want trustees to have very limited authority to carry out their objectives, whereas others may be more comfortable giving a trustee wide discretion to achieve those objectives. For some planning objectives, full discretion is mandatory. In other cases, the challenge is to strike a balance between the need for certainty and the need for flexibility. The choice of trustee will be one of the key factors in determining that balance. In all cases, it is important to consider all the circumstances under which the trust might operate and to draft the trust with a view to minimizing or avoiding strained relationships among family members, the trustee and the primary and contingent beneficiaries. Be careful to structure the trust so that it meets the legal and planning requirements and avoid using language that will result in costly court applications for directions or interpretation of the Will. Blind reliance on trust precedents that do not address all of the practical, legal and tax considerations of the particular case will expose you to potential claims.

In addition to powers that are given to trustees in a Will, trustees also have obligations or duties that are imposed by the relevant legislation and case law. For example, trustees have fiduciary duties, including the duty to act honestly and in good faith and to avoid conflicts of interest. Unless the trust instrument provides otherwise, trustees must also treat beneficiaries with an even hand. The *Trustee Act* includes rules relating to the investment of trust property. The *Perpetuities Act* limits the length of time property may remain in trust without vesting. The *Accumulations Act* avoids accumulation of income in a trust beyond certain periods. In practice, a trustee administering a trust under a Will would only be able to accumulate income in the trust

for a maximum of twenty-one years after the trust comes into existence.

In addition to various statutory provisions, regard must be had to various common law rules contained in the case law, for example, the rule in *Saunders v. Vautier*[1]. In practical terms, that rule states that if the beneficiary is sui juris (i.e. over the age of majority), and is the only person ascertained as having an interest in the trust property, the beneficiary is entitled to terminate the trust prematurely. In practice, the application of this rule is usually avoided by inserting a gift-over clause that identifies the other beneficiaries who may receive the trust property if the primary beneficiary dies before attaining a specified age.

The foregoing is a general and introductory overview of some basic trust concepts and rules. A thorough understanding of the statutory provisions and the common law is essential if the lawyer is going to help the testator achieve his or her planning objectives and be able to explain the limitations of the use of trusts in any particular case.

The following are some common examples of the use of trusts in Wills.

Trusts for Control Purposes

(a) *Trusts for Minors*

The most common example of a trust being used in a Will involves the disposition of an interest to a minor. If a beneficiary or contingent beneficiary is a minor, the Will should provide the executor with authority to hold the minor's interest in a trust at least until the

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[1] (1814), 4 Beav. 115, 49 E.R. 282, affirmed (1841), 1 Cr. & Ph. 240, 41 E.R. 482, [1935-42] All E.R. Rep.

minor attains the age of majority. If the Will does not contain a minor's trust and the minor's share in the estate exceeds $10,000.00, the executor cannot pay the funds to the minor's parent or legal guardian. The executor would be compelled to pay the minor's share into court.[2]Most Wills include a general clause directing an executor to hold a minor beneficiary's interest in trust and the executor/trustee is given discretion to allocate income or capital of the trust for the minor's benefit before the minor attains the age of majority.

It is now common to create trusts for young beneficiaries until they attain twenty-five or thirty years of age, particularly if the share of the estate allocated to such a beneficiary is substantial and the testator is concerned about the beneficiary's ability to manage large sums of money or how the beneficiary will spend it. Where a beneficiary's interest in the estate is delayed to a date past the age of majority,be mindful of the rule in *Saunders v. Vautier*and include a gift-over clause.

(b) ***Spendthrift Trust***

A testator may wish to control a beneficiary's entitlement to income or capital because the beneficiary has bad habits, i.e. drug or alcohol abuse, or does not have the skill or ability to manage money. These types of trusts are commonly referred to as "spendthrift" trusts and may take a variety of different forms. The trustee is usually given full discretion to distribute income or capital with a gift-over in the event any funds are left in the trust after the spendthrift dies. In other cases, the trustee may be authorized to make

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[2]*Children's Law Reform Act*, section 51(1.1)

periodic distributions so that the spendthrift cannot waste all of the money at once. In these situations, it is particularly important to give serious consideration to choice of trustee. Recognizing that the discretionary beneficiary may make excessive demands for distribution of funds, the trustee should be someone who is able to uphold the testator's objectives.

(c) ***Disabled Beneficiary (Henson Trust)***

Another example of a trust being set up to control the beneficiary's entitlement to the inheritance involves disabled adult beneficiaries. A testator will want to strike a balance between ensuring that the disabled beneficiary's needs are met while also being mindful that the beneficiary may be receiving government benefits under the Ontario Disability Support Program ("ODSP") and may lose the benefits if the inheritance is not properly structured.

Generally speaking, a disabled adult beneficiary will qualify for ODSP benefits if the beneficiary's income and assets are below threshold amounts prescribed by the legislation that governs the plan.

Since the disabled adult beneficiary's entitlement to ODSP benefits is based on the beneficiary being able to meet the income and asset test, a disabled family member should not be left an absolute gift which would have the effect that the beneficiary's assets or income exceed the threshold. The recommended planning solution is to leave the disabled beneficiary's portion of the estate in an absolute discretionary trust. These types of trusts are commonly referred to as "Henson trusts" based on an Ontario case, *Ministry of Community and Social Services v. Henson* (1987), 28 E.T.R. 121, 26 O.A.C.

332 (Div. Ct.), affirmed, 1989, 36 E.T.R. 192 (Ont. C.A.). The following is a summary of the key terms for a Henson trust:

(i) The trustee must have absolute discretion to distribute income and capital;

(ii) The assets must not vest in the disabled beneficiary;

(iii) The annual income not specifically allocated to the disabled beneficiary may be accumulated in the trust. The Will should provide for mandatory distribution of income to someone other than the disabled individual after the maximum period for accumulation of income permitted by the *Accumulations Act*;

(iv) The trust should indicate that the government benefits could be maximized;

(v) Provide a gift-over following the death of the disabled beneficiary.

Before drafting a trust for a disabled adult family member become familiar with the ODSP regulations and the permitted distributions and exemptions.

Trusts for Creditor Protection

In most cases, the testator will not want his or her hard earned money to be left to a beneficiary only to have the beneficiary's creditor seize those funds in satisfaction of the beneficiary's debt. This is particularly true in family law situations if the beneficiary has gone through a divorce or is in an unstable marriage.

If creditor protection is desired, the beneficiary should not be given a vested interest. The details of the trust terms will vary depending on the nuances of each particular case.

For example, Tom, a real estate contractor may not wish to hold title to a family home for fear that he may be sued and the family home may be seized to satisfy a judgment creditor. In that case, title to the family home may be registered in Tom's wife's name so as to avoid the home being available to his creditors. Subject to the compliance with fraudulent conveyances laws and other considerations, the home may be exempt from creditor claims while it is in his wife's name and she is alive. However, creditor protection may be lost if the wife dies and in her Will she leaves the home to Tom directly. If creditor protection is desired after she dies, she should leave the home in a trust. In that case, Tom may have the right to use and enjoy the home while he is alive but he would not acquire a vested interest in the property. Again, the trust should provide for a gift over after the spouse has died or no longer wishes to have the use and enjoyment of the property.

Tax Considerations to the Testator

It is beyond the scope of this paper to address specific tax planning considerations. The two key pointsthat we wish to make are:

(a) The testator's wish to minimize or defer tax consequences on death may affect how the gift is structured; and

(b) When the decision is made to set up special types of trusts (for example, a spouse trust), it is important that the trust comply with the requirements of the *Income Tax Act (Canada).*

For example, a farmer may wish to leave his farm property to his son. If the farm is a qualifying farm property within the meaning of the *Income Tax Act,* the farm may be transferred to the son without tax consequences at the farmer's death. However, for the rollover to apply, the farm

would have to be left to the son directly and not in a trust. This is not intended to be a general legal opinion on the taxation of farm property. It is intended to raise awareness of the fact that the tax implications to the testator may depend on how the gift is left to the beneficiary.

In addition to deciding whether an asset could or should be left in a trust, if a decision is made to create a trust, it is important that the trust be properly structured within the requirements of the *Income Tax Act*.

For example, an individual in a second marriage may wish to leave the residue of his estate in a trust so that the income of the trust is paid to the second spouse during her lifetime and the capital is left to his children from the first marriage on the second spouse's death. If this individual wishes to defer the payment of capital gain tax on the assets that will be allocated to the spouse trust when he dies, it would be important to ensure that the trust is a qualifying spouse trust within the meaning of the *Income Tax Act*. Some of the key requirements for a qualifying spouse trust are:

(a) The deceased taxpayer must have been resident in Canada immediately before his or her death;

(b) The transfer or distribution must occur as a consequence of the taxpayers death;

(c) The property must vest indefeasibly in the trust within thirty-six months of the date of death of the taxpayer;

(d) The trust must be resident in Canada immediately after the taxpayer's death. (This usually requires that the trustee is resident in Canada);

(e) The taxpayer's spouse is "entitled" to all of the income during his or her lifetime;

(f) No one other than the spouse is "entitled" to any of the capital during his or her lifetime.

A common mistake when drafting spouse trusts arises when qualifiers are added that would terminate the trust before the spouse dies. For example, in some cases, the trust is said to end if the spouse remarries. Such a condition would taint the trust and could lead to adverse income tax consequences on a testator's death. The adverse consequences being that the assets allocated to the trust may not be rolled over on a tax free basis and the tax obligation will have to be funded when the testator dies rather than on the second spouse's death.

While property may be left to a spouse for tax reasons that benefit the estate, a spouse trust may also be used for income splitting reasons that benefit the surviving spouse, or to control the spouse's access to funds or to protect assets from the surviving spouse's creditors.

When the trust is set up for control reasons, be mindful of the provisions of the *Family Law Act*, R.S.O. 1990, c. F.3, as amended. A legally married surviving spouse has a right to make a claim for an equalization of net family property. A spouse may also have a right to make a dependant relief claim within the provisions of the *Succession Law Reform Act*, R.S.O. 1990, c. S.26.

If the spouse trust is structured in a way that the spouse has limited or no access to trust capital or if the circumstances of when the trustee may encroach on capital are not clear or flexible, disputes may arise.

For example, consider the issues that may result if a spouse trust was drafted giving the trustee limited power to encroach on capital only in "emergency" situations and for "medical purposes." In such a case, there is no accurate way to predict future unexpected expenses that the surviving spouse may encounter. If the spouse has a medical emergency, the cost of which is addressed

under the encroachment provision of the trust, the particular health event creating the emergency may also create an ongoing need for expensive medical care for the spouse. Technically, an ongoing health situation would be difficult to describe as an "emergency." A stroke or heart attack may be an emergency when it occurs but the ongoing need for treatment may not meet the definition of an "emergency."

If the trustee continued to encroach on capital to pay ongoing health expenses, the remainder beneficiaries may well hold him accountable. In this example, the trustee would be well advised to seek directions from the court.[3]

This example illustrates the importance of giving careful consideration to possible contingencies and unexpected future events and how language limiting the trustee's power may lead to disputes and court applications that most clients would want to avoid.

Tax Implications to the Beneficiary

This is an often overlooked planning consideration. Even if the beneficiary is an adult and the testator has no concerns about controlling the beneficiary's entitlement to assets or protecting them from the beneficiary's creditors, it may still be advisable to leave that beneficiary's share in a trust for tax reasons that may benefit the beneficiary. The trust structure could provide income splitting opportunities and help the beneficiary reduce the amount of income tax that will be paid on income earned from the inheritance. Income splitting trusts are typically considered

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[3] An excellent example of a case where the trustees were required to seek interpretation of the terms of the Will in order to determine whether capital could be used for certain expenses for the spouse was that of *Goodfriend Estate (Re)*, 2003 CANLII 43947 (ON SC).

whenever the beneficiary is allocated a substantial estate, the beneficiary is already a high income earner and in a high tax bracket, the beneficiary is likely to hold and invest the inheritance, and has children with limited income from other sources.

To illustrate, assume that Bill, the intended beneficiary, is a forty year old professional and earns more than $125,000.00 in taxable income from his own endeavours. Assume that Bill's parent plans to leave Bill a $1,000,000.00 inheritance and that Bill intends to hold and invest the inheritance when it is received. Bill has two children,who are sixteen and fourteen years of age, with limited income of their own.

If Bill receives the inheritance outright, the inherited funds would be invested personally by Bill and the income from that inheritance will be added to his income from other sources and taxed at his marginal tax rate. If Bill is already in a high tax bracket, i.e. 46%, and the income from the invested inheritance is $50,000.00, income tax of $23,000.00 will be paid on the $50,000.00.

If a testamentary trust was set up and Bill and his children were named as discretionary income beneficiaries of the trust, the amount of income tax that would be paid on the same amount of income earned in the trust could be significantly reduced. This is because income in a testamentary trust may be taxed at graduated rates just like an individual, the only major difference being that the testamentary trust does not receive a personal exemption or credit that is available to an individual. Because the income from the inheritance could be taxed in the trust, the applicable tax rate on income of $50,000.00 would be less than 46% and would reduce the amount of tax that would otherwise have been paid if the inheritance was paid to Bill directly. If the trustee of the trust is also given discretion to allocate income of the trust to Bill's children and his children have no other substantial income, the tax savings can be multiplied. For

example, if $10,000.00 of the income from the trust was spent for the benefit of each of Bill's two children, each child could report $10,000.00 of income on his or her own personal tax return and pay no tax on that portion of incomethat would have been taxed in Bill's hands at 46% resulting in $9,200.00 in tax savings to the family.

The actual tax savings in any particular case will depend on a wide variety of factors including the size of the inheritance, the rate of return, the number of discretionary beneficiaries and their marginal tax rates.

Cost and Expense and Delegation

While trusts may provide benefits, it is also important to assess the potential cost and expense, including the following:

(a) The upfront cost of creating trusts and the associated professional costs and expenses both for legal and tax advice;

(b) The cost of maintaining the trust after the testator's death (i.e. the cost of preparing additional tax returns, record keeping, bookkeeping and trustee compensation).

There may be a point in time during the administration of a trust when the benefits of maintaining the trust outweigh the cost. On the other hand, if the trust is administered for a period of time and the costs start to outweigh the benefits, consideration should be given to possibly including special language in the Will that would allow the trustees to wind up the trust before a specified event occurs. The purpose of winding up the trust would be to avoid trust property being eroded by the carrying costs of the trust. The decision to wind up the trust could be left in the absolute discretion of the trustee.

While the creation and the administration of a trust will usually result in additional costs, it is also important to address how the costs of administration will be allocated and who will be responsible for them. In many cases, trustees are unable to perform all the required tasks and may want to delegate particular tasks to others.

The delegation of tasks in the administration of a trust by a trustee raise two key issues:

(a) whether a particular task can in fact be delegated; and

(b) whether the cost associated with the delegation of a task should be borne by the trust or if the cost should be deducted and paid from the compensation paid to the trustee.

Both of these issues should be addressed at the drafting stage.

The Will could include a provision that clearly states that the trustee is permitted to engage agents or professional advisors to assist the trustee with the administration of the trust. Indeed, most Wills now include such a provision. Note, however, that a trustee must be careful not to delegate his or her decision making authority.

If the trustee is permitted to retain agents, consider who will be responsible for the agent's fee. For example, if a trustee retained a lawyer or a trust company to prepare estate accounts, it is generally accepted that the fee so paid to the agent will be paid from the trustee's compensation rather than from the trust income or capital. This general rule applies to the preparation of trust accounts because the trustee is expected to be able to complete this task as a standard part of the trustee's obligation to administer an estate.

The above example may be contrasted with the trustee's obligation to seek legal advice and to have the legal fees paid from the estate because the trustee is not expected to have legal expertise. When an issue of legal interpretation arises, such as the need for directions from the court in understanding the testator's intentions, it is generally considered acceptable for a trustee to engage the services of a lawyer and to have legal fees paid from the estate.

A recent decision of the Ontario Superior Court of Justice in the *Estate of Elaine Jackson Young, deceased*, 2012 ONSC 343, deals with these types of issues in the context of the investment of trust property.

On the application to pass accounts, the Office of the Children's Lawyer raised an objection as to "whether investment management fees charged to the capital of the estate should be deducted from the compensation paid to the trustees." The central disagreement between the parties was whether the trustee had the relevant expertise to make investment decisions and maintain the management of the assets in the estate as a core function of the trustee's duties or whether an estate trustee should "be able to access professional investment expertise to properly administer an estate and should be fully indemnified for all costs and expenses" related thereto.

In the end, the court's decision was that the cost of investment management was properly allocated to the Estate's capital. The reasons for the decision were:

(a) investment markets today are complex environments;

(b) estate trustees should be entitled to engage advisors to maneuver through that complex environment; and

(c) the ordinary prudent investor would be entitled to engage an investment advisor, as such

so too should an estate trustee.

The court relied on the decision of *Miller Estate, Re:*, in which it was stated "(t)he ordinary prudent person in the conduct of his or her investment affairs turns now as a matter of course to investment counselors and advisors and it would be unfortunate if executors were not permitted to obtain such advice without deduction from compensation." Additionally, the court pointed to section 27.1(1) of the *Trustee Act*, R.S.O. 1990, c. T.23 which allows a trustee to authorize an agent to exercise a trustee's functions with regard to investing trust property in the same manner as a prudent investor would authorize an agent to exercise investment functions.

While it is open to an estate trustee to engage investment advisors, it is still necessary for the estate trustee to be involved in the formulation of the investment strategy and to oversee the work of the advisors. A written plan or strategy should be developed to ensure that the investment management is done in keeping with the overall objectives of the estate plan and in a prudent manner.

If the testator wishes to avoid disputes about delegation and about the allocation of expenses associated with the delegation of work, it may be helpful to include language in the Will that would serve to avoid disputes about these issues. Most trust companies address these types of issues in their standard fee proposals that can be incorporated by reference when a trust company is appointed as the trustee.

Conclusion

Trusts are flexible planning tools that may be specifically tailored to address the unique planning goals and priorities of each individual. It is important to be aware of all the practical, legal and

tax considerations. A balanced approach to drafting trust provisions is an important skill for any practitioner to develop.