AIRD BERLIS

Where's My Income?

Sep 13, 2019

By Donald Carr

It is sometimes suggested that providing for spousal trusts in "family wills" today is less frequent than before amendments to the *Income Tax Act ("ITA")* substantially removedthe ability to reduce income taxes by the use of them.

Nevertheless, my own experience dictates that, tax issues aside, many testators with a spouse and children still opt for protecting children and issue, as well as the spouse.

In those circumstances, the client expresses the wish to provide for the surviving spouse during lifetime, but to leave the remaining estate to their children at some stipulated ages.

The norm is to translate that desire into a trust which provides that all "income" is to be paid to the surviving spouse during lifetime, and the residue of the estate is divided in some manner - usually equally - among children, with gifts over to issue *per stirpes* on the spouse's death. It is also usual to give the trustees the discretion to encroach on capital for the spouse. The trust is fashioned so that it complies with the definition of "spousal trust" in the *ITA* and that no capital gains tax is imposed until the death of the survivor.

Frequently, the will provides that, in the trustees deciding on whether to encroach on capital for the benefit of the survivor, it is the testator's wish that the spouse be provided with sufficient funds so as to enjoy a standard of living to which he/she was accustomed during the testator's lifetime, or some similar wording.

An important factor in ensuring that the surviving spouse will be "looked after" is the nature of the assets in the spousal trust. In some situations, assets may comprise those which will likely provide sufficient income for the spouse, such as income-producing real estate or an active business which will continue. Thus, encroachments of capital do not have to be regularly considered.

However, frequently, the bulk of the assets in an estate comprises marketable securities held in an active brokerage account.

In days gone by, when securities' markets were acting "normally", there was not too much concern about such will provisions. A testator, by mooting, for instance, that annual net income of 5% to 6% was to be expected, would contemplate that the estate would produce sufficient annual income to look after the surviving spouse. Encroachments would not have been a major concern. They would, likely, only be used if unexpected circumstances were to arise.

However, we are no longer in those halcyon days. In fact, we drifted into a radically different market situation some years ago. For some time, interest rates have consistently been at, or close to, all-time lows. If, today, a trust, invested in securities, produces "net income" of about 1% to 2% per annum, the trust will likely be considered to be doing fairly well, insofar as "income" is concerned.

Contrary to history, during this market situation we have been living in the age of "total return". Investors and their brokers no longer concentrate on "income". They invest in portfolios which are planned, not just for income, but, substantially, if not primarily, for capital appreciation. "Combined return" is the name of the game. Except for the fact that capital gains are taxed at a lower rate, it seems immaterial whether the returns are in the form of income or capital gain. It would seem that this state of affairs is likely to continue for an indefinite period.

This situation may be fine for a living investor.

However, it's not so fine for a testamentary trust (or an inter vivos trust, for that matter), if that trust contains provisions such as outlined above, i.e. "income" to surviving spouse for life; power to encroach on capital for spouse; residue (remaining capital) for children/issue.

Even if a will provides a definition of "income" in the broadest of terms, it is unlikely for trustees to be able or willing to convert a normal capital gain realized in the market into "income" for estate or trust purposes.

In those circumstances, the surviving spouse, who is dependent on income, will thus receive substantially less than most testators anticipate and the trustees will be placed in the position of deciding what to do.

The logical thing to do is to exercise the power to encroach on capital for the surviving spouse. But, for how much?

In planning, little time (if any) is spent considering when trustees would be acting properly in exercising their discretion to encroach on capital for the benefit of the surviving spouse. Many lawyers and their clients seem satisfied that, if the surviving spouse is not getting "enough", encroachments on capital will be available. As indicated above, there may be a provision where the testator clearly states that the prime intention is ensuring the "welfare" of the spouse and ensuring that the spouse can continue to live in the manner in which he or she was accustomed during the lifetime of the testator. However, even those provisions can lead to disagreement as to acceptable or appropriate quantum of encroachment.

There is a plethora of reported decisions, as well as many references in textbooks, dealing with whether there has been a proper exercise of trustees' discretion to encroach. Many cases have concluded that the purported encroachment was improper, for multiple different reasons.

Leave aside, for the moment, the fact that in Ontario, the Children's Lawyer may well have a stake in the estate where someone under 18 years of age is a beneficiary of the residue of the estate, and will have to be satisfied about the propriety of an encroachment for the spouse. Are adult children going to be happy when there are encroachments on what they consider to be *their* capital? Many may be quite content that whatever their surviving parent requires should be made available. On the other hand, situations are legion where children have objected, whether because of bad relationships or just selfishness. And, particularly, there are situations where the surviving spouse is from a second marriage of the testator and the children are those of an earlier spouse, who is the only one considered by them to have been a parent. That is even more perilous.

Are there more appropriate alternatives?

A so-called "minimum benefit" provision might do the trick. One could provide for the greater of (i) a specified figure, adjusted for COLA and (ii) the net income per annum. However, even with a COLA adjustment, that, by itself, does not take into account what might be happening in the securities marketplace and will not necessarily affect how the trustees will deal with the asset mix in the investment portfolio.

The time is overdue for us to take a closer look at these situations and to revisit the venerable "percentage trust" – sometimes called a "unitrust" or a "total return trust".

This process has often been used in charitable remainder trusts, but has rarely been used in Ontario in family trust situations. It is now very appropriate to consider seriously its use for "family wills" or "personal" inter vivos trusts.

This different way of providing appropriately for a surviving spouse, without the perils of trustees regularly engaging in decisions whether or not to encroach on capital, and to what extent, means that the testator will provide in the will that the surviving spouse will receive annually the greater of (a) the annual net income and (b) a sum equal to X% of the ongoing fair market value of the assets in the trust. (It will be remembered that, in order to come within the definition of a "spousal trust" under the *ITA*, it is essential that the spouse be entitled to receive all of the income of the trust; thus the requirement for "the greater of"). The discretion to encroach on capital for the spouse to cover unanticipated, unusual situations will still be maintained.

This different approach will avoid the question of whether there has been proper or improper exercise of discretion to encroach by the trustees and, importantly, whether the portfolio of investments should be balanced differently to produce more income, causing unfairness to the residuary beneficiaries.

Whether one should stipulate that the percentage to be paid relates to the "net" or to the "gross" fair market value of the trust's assets is a question for discussion with the client.

Two excellent articles on this topic are recommended. In the U.S., Robert B. Wolf's "Estate Planning with Total Return Trusts" (*36 Real Property, Probate and Trust Journal of 2001*) and, in Canada, Anne Werker's "The Percentage Trust" (*23 Estates, Trusts and Pensions Journal, 329 (2005-2006*).

Wolf's article, which runs for well over 300 pages, is detailed and contains computer modelling, taking into account U.S. tax issues which, of course, are irrelevant here. It is, nevertheless, a great source of history and ingenuity.

Ms. Werker's article is in a Canadian context, has a much more generalized outlook, is not so concerned with detailed analyses of the markets or the economy, has references to relevant cases and is a little more recent.

There is, of course, no perfection. One cannot predict what market or economic circumstances may occur in the future. Deciding the "correct" percentage to be applied to the assets may be difficult. As commented above, Wolf ran computer models relating to various periods in investment history in order to arrive at a percentage figure and he recommended not using a percentage higher than 5% per annum.

Utilizing the concept of the percentage trust/unitrust/total return trust creates some certainty and removes several opportunities for disputes.

Author

Donald Carr
Counsel
T 416.865.3429
dcarr@airdberlis.com

This communication offers general comments on legal developments of concern to business organizations and individuals and is not intended to provide legal advice. Readers should seek professional legal advice on the particular issues that concern them.

© 2020 Aird & Berlis LLP. All rights reserved