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TRUSTS CREATED WITHIN A WILL = TAX SAVINGS

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Many individuals are unaware that by properly drafting their wills, they can save their beneficiaries thousands of dollars of tax each year.

A person's will can state that instead of distributing an inheritance directly to a beneficiary, the inheritance can be held in a testamentary trust.

A testamentary trust creates a separate taxpayer for income tax purposes, which has several benefits:

- The trust is subject to the same graduated tax rates as an individual, resulting in tax savings on investment income.
- An individual's will can provide separate trusts for each beneficiary, multiplying the tax savings.
- Creditor proofing of the assets is improved since the assets belong to the trust, not an individual.
- It provides better separation of assets for family law purposes.

A testamentary trust is created through clauses in a will that identify which assets are to be left to the trust. The testamentary trust can elect to pay tax on any income earned from the assets that were bequeathed to it. If the income is taxed in the trust, the beneficiaries would not pay tax on the remainder when they receive it.

For example, a deceased taxpayer's only beneficiaries were his two adult children, each entitled to 50% of his estate according to the will. The only asset of the taxpayer was an investment of \$2,000,000 yielding 6% interest. Both adult children are already in the highest tax bracket. The following illustrates the savings for an Ontario resident using 2009 tax rates:

	Each Child Without Testamentary Trust	Each Child With Testamentary Trust
Amount of inheritance	<u>\$1,000,000</u>	<u>\$1,000,000</u>
Annual income @ 6%	\$ 60,000	\$ 60,000
Taxes payable	<u>27,900</u>	<u>14,800</u>
Income retained	<u>\$ 32,100</u>	<u>\$ 45,200</u>
Net annual savings per child through a testamentary trust		<u>\$ 13,100</u>
Effective tax rate	<u>46.4%</u>	<u>24.6%</u>

The annual savings could be increased even further if the will specified that the beneficiaries of each testamentary trust were the families of each child, and that the income per family could be allocated at the discretion of the trustees. In our example, if one child had two adult children (grandchildren of the deceased), who had no other income, the \$60,000 earned in the trust could be allocated between the trust, the child, and his/her children. If the income were allocated \$30,000 to each grandchild instead of to the trust, the total taxes payable would be reduced from \$14,800 to \$9,000.

The will must also identify who the trustees of each trust will be. The trustees have the responsibility of controlling and administering the trust assets. The will usually contains several clauses outlining how the deceased taxpayer would like his estate administered and indicates on what issues the trustees have discretion. Often, the trustees are the beneficiaries themselves, family members, or professional advisors.

Spousal Trusts

Spousal trusts are useful when the taxpayer leaves a surviving spouse. A spousal trust is created in a taxpayer's will and is designed to be a tax-effective mechanism to provide for the surviving spouse:



- Spousal trusts take advantage of the rules relating to tax-free rollovers to a surviving spouse. The income taxes normally payable on death are deferred until the death of the surviving spouse.

- The spouse must be the income beneficiary and, therefore, be entitled to all of the income from the spousal trust for as long as the spouse is alive.
- Many wills include a clause that the surviving spouse can encroach on the capital of the trust if the income from the spousal trust is insufficient.
- Often, the surviving spouse will remarry. A spousal trust provides that on the death of the surviving spouse, the remaining estate is divided among the capital beneficiaries in accordance with the terms of the will. The surviving spouse's new family would not be entitled to any of the assets on the death of the surviving spouse.

Other matters

A separate tax return must be prepared for each testamentary trust. A trust does create some additional administrative costs, but usually the benefit of the tax savings outweighs the administrative costs.

If the beneficiaries do not want the trust, the terms of the trust could allow the trustees to wind up the trust. The assets would then be distributed to the beneficiaries.

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