

Leon Gluzman, CA
 Richard W. Fage, CA, TEP
 L. Gerald Levitz, FCA
 Bruce A. Johnston, CA, CFP, TEP
 Jeffrey N. Miller, CA, CFE, TEP
 Deborah M. Bouchier, CA, CFP, TEP
 Patricia Day, CA, CBV, CFP, TEP
 Hugh Faloon, CA, CFP, TEP
 John Baldwin, CA, CFP
 Alan Freed, CA, TEP



287 Richmond Road
 Ottawa, ON K1Z 6X4

Tel: 613-728-5831
 Fax: 613-728-8085
 E-mail: info@ggfl.ca
 Web site: www.ggfl.ca

TRUSTS CREATED WITHIN A WILL = TAX SAVINGS

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

The major benefit of a testamentary trust is that it creates a separate taxpayer for income tax purposes. The trust is subject to the same graduated tax rates as an individual. An individual's will can provide a separate trust for each beneficiary. A testamentary trust can also be used to protect the assets from creditors.

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 using 2004 tax rates:



	<i>Each Child Without Testamentary Trust</i>	<i>Each Child With Testamentary Trust</i>
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>16,000</u>
Income retained	<u>\$ 32,100</u>	<u>\$ 44,000</u>
Net annual savings per child through a testamentary trust		<u>\$ 11,900</u>
Effective tax rate	<u>46.4%</u>	<u>26.7%</u>

The annual savings could be increased 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 children (grandchildren of the deceased), who had no other income, the inclusion of appropriate clauses in the will could allow the trustees to allocate \$60,000 of trust income 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 \$16,000 to \$10,000.

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 take advantage of the rules relating to tax-free rollovers to a surviving spouse. A spousal trust would be drafted to ensure that on the death of a surviving spouse, the children and other desired beneficiaries receive the remaining capital of the estate.

Spousal trusts are useful when the taxpayer leaves a surviving spouse. Typically, the spouse is the income beneficiary and, therefore, is entitled to all of the income from the estate for as long as the spouse is alive. On the death of the surviving spouse, the remaining estate is divided among the capital beneficiaries in accordance with the terms of the will.

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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