Beyond Ruling from the Grave

by Cindy David, CFP, CLU

One of the first implemented steps in most estate plans is the all-important Will, outlining how your financial affairs are to be handled and your assets distributed when you pass on. There is a level of control provided by ensuring that you – not the province – decide who receives the benefits of your material goods and the savings you've built over your lifetime. Often, your ability to provide direction stops once your effects have been handed out. However, by making use of trusts, your ability to provide guidance is considerably expanded.

There are essentially two types of trusts in Canadian law: inter-vivos trusts, which you create during your lifetime, and testamentary trusts, which are created after you pass on. Within those two main types there are several variations. Since the focus of this publication is on estate planning, we'll concentrate on testamentary trusts.

A testamentary trust is typically created in your Will, but can also come from the proceeds of a life insurance policy. A trust can provide control, flexibility, an opportunity for income splitting, and creditor protection.

Control & Flexibility

You can create a testamentary trust that leaves control in the hands of the beneficiary(ies), or in the hands of a third party – a trustee – who will manage their affairs according to the wording of the testamentary trust. You can design the trust so that specific amounts or percentages are available for the trust beneficiary for use or for income, or you can allow the beneficiary the opportunity to make those choices according to their needs.

When the beneficiary of the trust passes on, you can choose to have any remaining capital in the trust be distributed to their children in trusts and held until each one reaches a specified age of your choice. Alternatively, you can request that the remainder be split among other trusts you've created, or distributed in another manner. The choice – and however much influence you would like to have over the distribution of the trust's assets during and after the lifetime of the trust's beneficiary – is up to you.

Income Splitting

A testamentary trust is considered by Canadian law to be a separate taxpayer, and has the benefit of being taxed at the same graduated tax rates as any individual; the only exception being that a testamentary trust does not qualify for a personal exemption. The advantage for the trust's beneficiary is that income earned in the trust can either be taxed in the hands of the trust's beneficiary or in the trust itself.

Income splitting between the trust and the beneficiary allows for the opportunity for the income to be taxed at a lower rate than it would be if 100% of the income were taxed solely in the hands of the trust's beneficiary. The total income can be split by having the trust pay some of the tax on that income, and the beneficiary pay some of it.

For example, the first $35,716 of earned income in BC is subject to a combined federal and provincial tax rate of about 20.06%. The rate then jumps to 22.7% at $35,717, then 29.7% at $40,727, and again to 32.5% at $71,434 and onwards to the highest rate of 43.7% on income over $126,264.

Imagine if the beneficiary of your Trust – let's call him Ben – is already earning about $50,000 per year from his current career. You decide that you'll leave Ben $750,000, and he places it into a guaranteed investment earning 4% annually ($30,000). Let's see how that would get taxed if it were held entirely in Ben's hands, or if he were able to split the income with a testamentary trust.

Without a testamentary trust:

Tax Bracket	Tax Rate	Inheritance Income Earned	Additional Tax Payable
$40,726 - $71,433	29.7%	$20,033	$5,949.80
$71,433 - $81,451	32.5%	$9,967	$3,239.28
	Totals:	**$30,000**	**$9,189.08**

Allocating 100% of the inheritance income to a testamentary trust:

Tax Bracket	Tax Rate	Inheritance Income Earned	Additional Tax Payable
$0 - $35,716	20.06%	$30,000	$6,018
	Totals:	**$30,000**	**$6,018**

By directing the inheritance into a testamentary trust for Ben, the tax payable on the income earned from that inheritance is reduced by 35%, saving $3,171.08 over the year - a truly significant benefit!

If you have more than one beneficiary, the opportunity for income splitting is further increased by providing each with their own testamentary trust, as this will create an individual tax payer for each beneficiary with which to split income.

Creditor Protection

Creditors and, sometimes, marital discord of beneficiaries, can create anxiety for anyone wanting to leave significant assets behind. You wouldn't want to provide a gift that is subsequently handed out to lenders and ex-spouses. Placing an inheritance in a trust provides a level of protection from these claims. As the actual ownership of the assets belongs to the trust and not the trust's beneficiaries, your heir's interest in the trust is very difficult to lay a claim on.

However, once income is distributed from the trust into the hands of the beneficiary, it is open season on those funds. The trustee can make a decision as to how much and how often the income is distributed to best suit the needs of the beneficiary, which can allow for continued growth on the inheritance while it remains in the trust, thereby increasing the opportunity for those funds to continue to be available and protected for the trust's beneficiary.

Insurance Proceeds

The proceeds from an insurance policy, when a beneficiary is named, pass outside of the Will both tax and probate-free. However, naming an individual directly means that they cannot benefit from the control, flexibility, income-splitting and creditor protection opportunities of a testamentary trust. What is worse is naming your estate and having to pay probate.

Creating an Insurance Trust Declaration – a separate document from your Will – produces a testamentary trust which exists solely for the purpose of receiving the proceeds of an insurance policy. The trust becomes an individual taxpayer when you pass on and receives the proceeds as the named beneficiary of your insurance policy, providing both the tax-efficiency of a named beneficiary, and all the benefits of a testamentary trust.

It is recommended that the trustee of the insurance trust be a different person than the executor of the Will; this ensures that it is very clear that the proceeds of the insurance policy do not make up part of the estate. Creating the trust declaration as a separate document from the Will also ensures that, should the Will be challenged, the trust will not be revoked. There is of course an additional cost to set up this separate document, which duplicates some of the terms of the Will, so this must be weighed against the importance of protecting the proceeds and keeping them separate from the estate.

Whether you decide to set up testamentary trusts in your Will, or an insurance trust in a separate declaration, it is of the utmost importance that you consult qualified legal and tax professionals to help you through the process. ◆

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