



Tax ALERT

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Tax ALERT is a synopsis commentary on topics of special interest – usually topics relating to recent changes in the law, administrative practices or interpretations by taxation authorities. Professional advice should be obtained before acting on any of this information.

USING TRUSTS IN YOUR WILL

Much innovative tax planning can be done using trusts - either during one's lifetime (intervivos) or on death (testamentary). The purpose of this article is to discuss some planning ideas using testamentary trusts incorporated into wills. Family trusts established during ones lifetime also hold many tax advantages for the tax savvy and will be discussed in a future **Tax ALERT**.

Trusts can be broken down into two further major sub categories for tax purposes – spousal trusts and non-spousal trusts. Exhibit A outlines the important characteristics of each. The most important issues with respect to testamentary trusts are as follows:

- Testamentary trusts enjoy the advantage of personal marginal tax rates as compared with the top marginal rate which applies to all of the income of an intervivos trust.
- Spousal trusts permit the transfer of appreciated property from the estate to the trust on a tax-free basis but unrealized gains will be taxable when assets are distributed or deemed to be distributed to beneficiaries. On the other hand, non-spousal trusts require the payment of tax on unrealized capital gains when property is transferred to the trust but capital distributions from the trust can be made on a tax-free basis.
- With proper planning, trust income can be allocated to beneficiaries on a discretionary basis or taxed in the trust or both - whichever is most advantageous.

◆ Planning for Surviving Spouse

Most wills provide for the transfer of assets directly to the surviving spouse on the death of the first to die. However, this means that lower marginal tax rates otherwise available, had a separate trust been established, will not be available to the survivor since the income from inherited assets will be added to the surviving spouse's existing income. If a trust had been established, the trust income could be taxed separately allowing for utilization of marginal tax rates instead of the higher rate of the survivor and sprinkling of future income to various beneficiaries. Potential tax savings can be significant.

It can also be advantageous for a will to provide for the establishment of both a spousal trust and a non-spousal trust (to include the spouse and other family members). Estate assets will be distributed between the two trusts at the discretion of the trustees. Generally, appreciated assets will be allocated to the spousal trust to avoid capital gains at the time of death and the unappreciated assets will go to the non spousal trust. The mix can be changed later if desired.

For maximum flexibility, the surviving spouse should be a beneficiary of both trusts where two trusts are created. The terms in the will should provide for generous encroachment rights for the surviving spouse both as to income and capital in each trust to permit the surviving spouse to maximize tax-planning options. The surviving spouse is normally interested in access to trust capital (not necessarily trust income) in order to maximize the benefit of the separate taxation of trust income.

◆ **Planning for Children**

A second planning opportunity exists with respect to the passing of property to children. Again, testamentary trusts enjoy the advantage of marginal tax rates on the first \$114,000 of income so as much estate property as possible should pass to testamentary trusts for each child and not to the children directly - providing this is in keeping with the desired planning of the deceased. Again, such trusts would have broad provisions for encroachment both as to income and capital to allow children to take out capital or even collapse the trust if they wish. Because adult children with high paying jobs are often in high personal tax brackets, the use of a testamentary trust will lower their taxes. Once the income has been taxed in the trust, it can be passed to children tax free as capital distributions.

◆ **Planning for Grandchildren**

Why not also set up trusts for grandchildren. Their parents can be the trustees and control distributions. Income can be allocated to them without tax attribution and effectively shielded from personal tax using personal exemptions, tuition fees and the like. You don't even have to pay distributions in cash. Do them with a note payable and distribute the money later by redeeming the note.

◆ **The Magic of Trusts**

The flexibility of trusts is their real elixir. Most trusts should be discretionary so income and capital can be allocated amongst beneficiaries in any proportion at any time. This permits the trustees to cherry pick the best planning options within the framework of the rules set out in the trust document by the person who established the trust. The array of potential benefits is as wide as you want to make it. And, in the end, most trusts can be terminated when the time comes with little or not tax cost.

◆ **Save on Probate Fees**

When assets pass to the surviving spouse probate fees apply. Then when the survivor dies probate fees apply again on all assets. If the first spouse leaves assets in a trust for the surviving spouse, probate fees does not apply when these assets are distributed from the trust

◆ **Conclusion**

Tax planning on death using trusts provides significant opportunities to reduce income taxes. It's one of the few really good personal tax planning areas left. There are probably other tax planning applications not considered here – it depends on the circumstances. When each situation is analyzed, the picture will emerge. Using trusts is a practical thing to do – set out the rules you want played by in the trust and see the benefits of transfers to other family members now – you can't see them after you die.

ATTRIBUTES OF SPOUSAL AND NON SPOUSAL TRUSTS

<i>Characteristics</i>	<i>Spousal Trust</i>	<i>Non Spousal Trust</i>
Who is taxed		
Income	Trust income must be allocated to spouse (1)	Per trust agreement
Capital gains	Trust or spouse (1)	Per trust agreement
Trust tax rate		
Intervivos trust	Allocated to spouse	Top rate
Testamentary trust	Allocated to spouse	Marginal rates
Beneficiaries		
Income	Spouse	Per trust agreement
Capital.	Spouse only (2)	Per trust agreement
Property transfers to trust	Tax -free	Taxable
Property transfers to beneficiary	Taxable	Tax-free
Deemed disposition of trust property	On death of spouse - then every 21 years	Every 21 years

- (1) An election can be made to have allocated trust income taxed in the trust (Section 104 (13.1) and (13.2)).
- (2) In a spousal trust, the spouse must be entitled to receive all of the income of the trust and no person except the spouse is entitled to receive capital of the trust (Section 70(6)).

*Personal Wealth Strategies provides **Tax ALERT** for clients and business associates on topics of current interest. We do not expect that all topics covered in **Tax ALERT** will be important to everyone but hopefully most readers will take away something helpful from time to time.*

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