The TaxLetter®

Vol. 28, No. 5 | Your Guide to Tax-Saving Strategies | Single Copy: $10.00 May 2010

ESTATEPLANNING

Leave your loved ones a greater estate with a...

Well-planned will

Samantha Prasad LL.B.

Planning for your death is not a pleasant thing to do; in fact, whenever I mention it to clients, they try to change the subject.

I don't blame them – who wants to think about his or her mortality? But the only thing worse than dying is the idea that your last two cents could be going to the tax man instead of to your kids.

So keep that thought in mind and read on to see how planning your will is not just about who gets the silverware; rather it's how best to maximize your estate so that your kids can afford to buy their own silverware.

Testamentary trusts

One of the most important tax strategies to include in your will is the "testamentary trust." Here's how it works. When you pass away, your estate is treated as a separate taxpayer, which can take advantage of low tax brackets.

This means that your children can "income split" with the estate. This opportunity has been made even more lucrative because of a rule that says the estate can choose to declare and pay tax on its income even though it is actually paid out to beneficiaries.

To take advantage of this opportunity, your will should make it clear that, when you pass away, your estate can continue for a number of years.

Often, the will simply leaves assets to beneficiaries "outright." In these cases, many estate planning experts question whether this favourable tax effect can continue for a prolonged period of time.

So it's better to make sure that your will is clear. That way your estate can continue. This is done by establishing what tax advisors refer to as a "testamentary trust" within your will.

In fact, this tax-saving concept can be taken even further by establishing several of these testamentary trusts within your will, perhaps one for each of your children.

Each of these trusts can potentially be taxed separately, so that the income splitting advantages I have already mentioned can be multiplied. Specifically, each testamentary trust is eligible for its own low tax bracket.

One word of warning: CanRev has the power to lump beneficiaries together when the bequests ultimately accrue to the same beneficiary or "group or class" of beneficiaries. In that case, the multiple trusts will be treated as one common trust for a larger group of beneficiaries.

Having said this, there are few reported cases where CanRev has successfully taken this position. Happily, there are CanRev missives that suggest this rule ought not to apply where you set up a separate testamentary trust for each child.

The spousal trust

You can defer your death tax exposure by making your spouse the beneficiary of your estate. Or better still, leave your assets in a qualifying spousal trust.

This trust can actually combine the tax-deferral advantages of leaving assets to a spouse dur-

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.
sprasad@mindengross.com

ing his or her lifetime with the ability to protect your family interests after you are no longer around to do so.

Specifically, the tax rules state that bequests to a spousal trust (or to your spouse outright) will not trigger capital gains tax on your death. Assets transferred to the spousal trust will occur on a tax-deferred basis (meaning, the tax won't have to be paid until the death of your surviving spouse).

The bonus of a spousal trust is that you can choose trustees to protect the surviving spouse against poor financial decisions. It will also ensure that the surviving spouse will not be able to transfer assets to undesired beneficiaries (such as a new spouse of his or her own choosing).

However, you must make sure that the spousal trust qualifies for the tax-deferred treatment; otherwise, no tax-deferred rollover will be available upon your death. Specifically, the spousal trust must meet the following requirements:

- The spouse is entitled to receive all of the income of the trust while he or she is alive;
- AND no other person (including kids) may receive or otherwise obtain the use of any of the trust's income or capital.

Note: just because no one else is allowed to receive the capital of the trust this does not mean that the spouse is automatically entitled to the capital.

In other words, as long as no other person has received or obtained the use of the capital (i.e. the capital simply sits in the trust), the spousal trust will not be disqualified.

In order to make sure that you do not go offside on these requirements, care should be taken when drafting your will and the clauses relating to the spousal trust.

For example, if the spousal trust allows for the trustees to loan funds on an interest-bearing basis to a relative, this could be interpreted as allowing someone other than the spouse to receive or obtain the use of the capital. It may be okay, however, to loan funds on commercial terms; but this should be checked with your advisor.

Happily (relatively speaking, of course), a spousal trust can provide for certain testamentary debts to be paid, like funeral expenses and income taxes payable for the year of death and prior years.

Probate planning

In Ontario, probate tax of 1.5 per cent will be payable on the value of your assets that go through probate.

However, if you own shares of private companies, you should ensure that you have a secondary will that deals only with those shares. Why? Well, you may be surprised to know that shares of private companies are not subject to probate tax. Accordingly, by segregating these shares in a separate will, you can avoid the probate tax.

This can result in substantial savings if the bulk of your wealth is tied up in private company shares. Therefore, if a secondary will is drafted to deal with these shares specifically, then the application for probate will only be made in respect of the assets in your first will.

And if you want to take this a step further, you can look into transferring legal title only (NOTE – not beneficial ownership) in your home and/or investments to a bare nominee company. Then have the shares of the bare nominee company dealt with under this secondary will so you can avoid probate tax on these assets as well.

The trick is that you are not actually transferring any real ownership in your house or investments to the nominee company – you're only putting the nominee company as the "named" owner, who will then hold such assets in trust for you.

The reason this avoids probate fees is that upon your death, you do not need to transfer the name on the title of your house or your investments since it stays in the name of the nominee company. You simply transfer ownership of the nominee company to your beneficiaries.

Again, I would suggest you speak to your advisor about the legalities of this transfer before proceeding to ensure that it is done correctly.

RRSPs and RRIFs

I recommend that you designate a beneficiary of an RRSP or RRIF directly in the contract itself rather than in a will.

Not only will this avoid probate fees, but it ensure that the value of your RRSP or RRIF is not be included as income in your final return if you designate a spouse as a beneficiary (which I highly recommend).

If your spouse passes away before you, or you get divorced, you can designate a child or grandchild who is "financially dependent" on you such that the RRSP will be taxed in the hands of the low tax rate of the child or grandchild.

The financially dependent child or grandchild can also take advantage of a special annuity which will enable him or her to defer this tax while a minor – or indefinitely if he or she is mentally or physically disabled.

Charitable gifts

"Financially dependent" usually means that the child or grandchild's income does not exceed the basic personal amount.

Your will can provide for gifts to registered charities, which, if done in the year of death, can qualify for tax credits up to 100 per cent of your net income.

Although this sounds like a great tax planning opportunity, beware the pitfalls that are abound in this area.

Care must be taken when drafting your will. CanRev used to be of the opinion that if the executors had discretion to choose the value of the bequest and to choose which charity would receive the gift, the donation would not qualify for the tax credit.

This position has been reversed; however, speak to your advisor to ensure that an amount to be donated is determined (whether a specific amount or a percentage) and it is clear from the terms of the will that the executor is required to make the donation to a qualified donee. ❐