Ensuring a seamless transfer of wealth with an estate plan

Estate planning is the process required to transfer and preserve your wealth in an effective and seamless manner.

There are various techniques to achieve the objective of a well-organized estate plan. What's surprising is that so few have taken the time to create an estate plan that can help organize their assets, minimize taxes and pass along their estate in the manner they intend. The predictable result is excess tax paid on retirement assets. When the time comes to settle the estate, its value may be substantially diminished. Many people simply have not made estate preservation a priority.

There are several strategies available to transfer assets to the next generation or to charities; a Will, a trust and insurance are effective tools to achieve this objective. A properly drafted Will is the foundation of a strategic estate plan. The Will arranges for assets to be transferred to family members and heirs. Establishing a trust for your children helps to maximize future tax savings and ensure a lasting family legacy. A life insurance policy can provide coverage for anticipated taxes at death.

Your legacy begins with a Will

A Will is an important document that everyone should have. A Will is the only legal document that can ensure that your assets will be distributed to the beneficiaries or heirs of your choice in the way that you wish and in a seamless manner with the least amount of tax payable. In the absence of a Will your assets will be distributed by the government in a process known as probate.

Your Will comes into effect only after your death. You may rewrite or amend your Will at any time and at minimum it should be reviewed annually. In addition, you should review your Will if your family needs or marital status has changed, your assets have increased or decreased, you have moved to a new province or jurisdiction or new laws have been legislated that will affect your estate plans.

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If you don’t have a Will, or have one that is invalid, the settling of your estate could lead to disharmony and inconvenience for the surviving family members. Not having a valid Will at the time of death is termed being intestate. It means you have not left instructions for how you want your assets to be distributed at your death, and you have not appointed anyone to be legally in charge of your estate. Accordingly, provincial legislation covers the procedures for intestacy. The court eventually appoints an administrator, and your estate will be distributed in accordance with the formulas of the law in your province. This process can be inflexible and may not reflect either your personal wishes or the needs of your family.

What’s in a Will?

Depending on the complexity of your estate, your Will could be simple or complex. Various items may be included in a Will:

- The identification of the person making the Will (the testator)
- A revocation of all former Wills and codicils (a supplementary document to a Will which may change, add or delete wording from the original Will
- Appointment of an executor[1] and possibly a trustee
- Authorizations to pay outstanding debts, including taxes, fees, funeral expenses and other administrative expenses before any gift of property can be made
- Appointment of a guardian for dependent children, in terms of their care and upbringing in the event of parents’ death
- Funeral instructions regarding funeral arrangements and the disposition of the body
- The disposition of your property to those individuals or organizations who will receive part of your estate

Disposition of property

The disposition of property is a major function of your Will. That is, how your estate will be distributed between your heirs and beneficiaries.

Specific property

It is common for people to leave a particular item of property or cash legacy to a particular person. If you want to give personal bequests, that is, specific articles of personal property, you should state so expressly in your Will. You can attach a separate piece of paper, referred to in your Will as a memorandum or letter of wishes. Describe the item in sufficient detail and identify the beneficiary by his or her full name and address.

Gifts of cash

- When giving cash legacies, you should periodically review the amount to be given to ensure that it is still sufficient and that it reflects your intentions. You may wish to increase the value of specific cash legacies every few years to account for eroding power of inflation. You should also make sure that there will be sufficient funds in your estate to cover any cash legacies.

A Will is an important and detailed document to administer an estate, and you should seek professional legal advice when preparing a Will.

Why use a trust?

A trust is a special way of holding property which, if structured properly, can provide protection from creditors, can guide the management and use of your wealth during your lifetime and after death, and can serve as a strategy to reduce various taxes. If you wish to transfer your wealth to your children but you have concerns about their ability to manage the wealth, or if you worry that your children may not protect and preserve the wealth beyond their lifetime (perhaps due to a spendthrift lifestyle or marital difficulties), using a trust as a vehicle to transfer your wealth across generations may be the solution.

There are two main types of trust: living ("inter vivos") and testamentary. A living trust is established while you are alive, and comes into effect once the trust agreement is signed and the trust is funded. A testamentary trust is created under the terms of your Will, and it is funded from the proceeds of your estate when you die.

The mechanics of a trust

The term trust symbolizes a relationship which is created when a person who initially owns property (the settlor) transfers possession and legal ownership of the property to someone else (the trustee/s) to hold the property for the benefit of someone else (the beneficiary/ies) according to certain terms. In order for a trust to be validly created, three things must be defined:

1. Express (verbal or written) intention of the settlor to permanently give up possession and control of the property and to create the trust accompanied by delivery to the trustees of the trust property.
2. Clear and precise description of the property to be held in the trust.
3. Clear and precise description of who the beneficiaries are.

These are referred to as the three certainties.

The trust is not a legal entity, but, under the Income Tax Act, it is considered a separate taxpayer for income tax purposes. It is the trustee who represents the trust because he or she has legal rights to the property. Therefore, only the trustee can take actions on behalf of the trust. The trustee must act according to the intentions of the settlor as expressed in the trust document (commonly referred to as the trust declaration, agreement, deed or instrument). The beneficial ownership is conferred to the beneficiaries, and the trustee's actions are rooted in his or her fiduciary duty to act in the best interest of the beneficiaries.

It is the separation between legal and beneficial ownership that gives the trust its flexibility in the control and protection of the trust property, and the management and distribution of the trust property.

The trust declaration

A properly drafted trust declaration is a crucial part of an effective trust structure. The trust declaration reflects the settlor's intentions and outlines the powers granted to the trustee. In particular, it contains instructions to the trustee regarding how income and capital distributions are to be made, when and to whom. The trust declaration determines when the trust will be terminated and who the ultimate beneficiaries will be (perhaps other family members or charities).

In Canada, in addition to the three certainties, a trust must meet certain requirements in order to be valid. This means that the language used in the trust declaration – the terms of the trust – must be considered carefully. For example, a trust cannot exist indefinitely. Properly structured, a trust can be used by a grandparent to provide for the distribution of his or her wealth to grandchildren who are not yet born. The choice of trustee must also be considered carefully.

Among other requirements, the trustee should possess sufficient knowledge regarding financial affairs including investments. They should not be in a position of conflict with any of the beneficiaries' interests. In some circumstances it is appropriate to appoint a professional – or corporate – trustee. This option has several advantages. A corporate trustee is not related to any family members who are beneficiaries, so is truly independent, with no conflict of interest. Unlike a person, a corporate trustee cannot die or become incapacitated, leaving a void in the administration of the trust.

Advantages of using a trust

Properly drafted, trusts can provide various advantages and tax benefits. For example, without a trust your assets may be vulnerable to creditors, may be depleted by spendthrift family members or subject to higher taxes.

Generally, property held in a trust for the benefit of others is not subject to probate tax (or probate fees, depending on your province) on your death since such property does not form part of your estate.

Limited tax benefits of testamentary trusts

Since 2016, testamentary trusts can no longer take advantage of graduated tax rates beyond a period of three years after date of death (in certain situations). However, all trusts continue to have tax-related (in addition to non-tax) benefits. The trust is a taxpayer, and as such, it must file annual income tax returns. Where a beneficiary's rate of tax is lower than that of the testamentary trust, then, depending on particular circumstances, income splitting and therefore tax reduction can be achieved.

The family trust

A reduction in probate tax and income tax across generations can be achieved by using a trust. Your adult children and grandchildren can receive income and capital distributions during your lifetime and pay less income tax than you would, if they are earning at a lower tax bracket. On your death, your estate would not have to pay probate on the property held in a trust and your children and grandchildren would continue to receive income and capital distributions. On the death of an adult child, any property still held in the trust would not be subject to probate, saving probate tax on the estate of your child. Your grandchildren could continue to receive income and capital distributions from the trust after the death of their parent, depending on the specific terms of the trust you created.

Trusts for adults with disabilities

Trusts are often used for the benefit of a disabled beneficiary without jeopardizing the right to government disability benefits. It is also possible to create a trust for a spendthrift beneficiary and structure it to prevent the depletion of trust assets and provide protection from creditors. The asset protection and tax planning opportunities provided by a trust make it an attractive estate planning tool. Trusts are extremely flexible and can be tailored to address specific needs.

Professional advice is essential when creating a trust. The rules concerning trust provisions can be very complicated, and tax laws can change. You should seek expert advice from a legal and tax professional who deals in Wills and estate matters.

Life insurance

Life insurance for wealth transfer can be highly effective during your life or after, depending on your personal situation. Life insurance enjoys unique treatment under the Income Tax Act. Consider using it to reduce or eliminate your taxes, providing more tax-free funds for family members and favourite charities.

Generally, a life insurance policy can cover debt obligations or provide income protection for a surviving spouse or partner. It may also cover estate tax liabilities to minimize the tax burden at the time of death. This is especially important if assets like a cottage or business have appreciated in value and you want to pass on these assets to beneficiaries, and not be forced to liquidate them to pay the tax liability.

Life insurance can also provide liquidity for an estate. For example, if there are two siblings and one of them is more interested in taking over the family business or keeping the family vacation property but they will not be able to afford to buy out the other sibling's half of the inherited property, life insurance may provide the estate with sufficient funds to pay out the other sibling in cash and thus equalize the estate.

Transferring wealth now versus later

You can also transfer wealth to a child or grandchild tax efficiently during your life by buying an insurance policy on the life of the child or grandchild. As the owner of the policy, you pay the premiums and overpay to build up the cash value. The growth of investments within a permanent life insurance are tax sheltered, within certain limits. The insurance policy is transferred on a tax-free rollover basis to the child, as long as the child is the life insured under the policy. If you transfer the policy to the child once he/she is 18 and there is a policy gain, that income is attributed to the child, and they will have access to the cash value.

It is worth noting that attribution rules may apply and you may be liable for taxes payable on the growth if the child withdraws from the policy before the age of 18. Another factor that may affect this wealth transfer strategy is the owner's premature death. You should name the child as the successor owner of the policy, in case you die before transferring ownership to the child when they turn 18. In this case, the policy bypasses the estate and is directly transferred to the child. This prevents a disposition of the policy, which may result in taxation on your final return.

Passing on your wealth to the next generation is a possibility. Whether that happens before or after your death depends on your estate planning goals. Work with an experienced insurance professional who can assess your needs and suggest appropriate strategies to achieve your goals.

Final thoughts

With proper planning you can ensure that your estate is managed according to your objectives and your wealth is transferred as efficiently and effectively as possible. Speak with your BMO financial professional to determine if these wealth transfer strategies are appropriate for you.

[1] An executor is a person, or a corporation appointed to administer an estate and ensure instructions in the Will are followed.

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