Tax Planning for an Inheritance and the Use of Testamentary Trusts

Having a valid Will and keeping it up-to-date is important. A valid Will enables you to protect the value of your assets, choose the manner and timeline in which your estate will be divided and to whom. If you die without a valid Will, the rules of intestacy would govern the administration of your estate and the distribution of your assets. In that case, your assets may pass to individuals who are not your intended beneficiaries. Furthermore, if you die intestate, you may expose your estate to family law or dependants' claims.

Having a valid Will in place at the time of your death enables your estate to utilize probate tax and income tax advantages under the Income Tax Act, to ultimately benefit your beneficiaries.

Understanding the possible tax benefits of a testamentary Trust requires the skill of a professional who specializes in estate planning. If you are looking to take your estate planning that "extra mile," your BMO Nesbitt Burns Investment Advisor can help introduce you to an estate planning professional who can discuss opportunities for your spouse, children or grandchildren, to save taxes in the future through the use of testamentary Trusts. The inclusion of Trusts in your Will can give your beneficiaries a greater after-tax return on the investment income earned from their inheritance. Likewise, if you are expecting an inheritance from your parents, you may want to involve them in a conversation regarding the inclusion of testamentary Trusts in their Wills to reduce your family's tax bill in the future.

A Testamentary Trust is a Trust created on death, usually by way of a written document such as a Will or a Trust Declaration, with respect to proceeds of a life insurance plan, providing the opportunity for a unique tax advantage: the testamentary Trust is taxed as a separate individual taxpayer at the graduated tax rates. Income earned in the Trust which is paid to beneficiaries can be taxed at the lower marginal tax rates of either the Trust, or a particular beneficiary.

Depending on the province and the income earned in the Trust, the tax saving on the Trust's lower rate can be up to approximately $13,000 every year. The maximum tax saving applies primarily to the first $30,000 of income, where income is taxed at the lowest marginal rate. Greater savings can be generated by further income splitting, where multiple Trusts for separate beneficiaries are set

up, or where a Trust permits income to be paid, or *sprinkled* on a discretionary basis, to other family members who themselves may be taxed at lower rates. These can include the deceased's spouse, children and grandchildren. An advantage of a Testamentary Family Trust is that the distributions from that Trust can be made at the discretion of the Trustee, providing maximum flexibility, tax savings and creditor protection.

This type of planning could be a useful strategy if you expect that the inheritance you leave might be more than your children or family members will (or should) spend on debt reduction and lifestyle. To determine this, you need to estimate the approximate value of your estate and the financial position of your children or other beneficiaries.

Remember, by the time your children receive their inheritance, their income may already be at or close to the highest marginal tax rate. Additional investment income which they receive as a result of inheriting from you, will also be taxed at the highest rate. If this income is earned in a testamentary Trust you have set up in your Will, the overall tax your child would be subject to may be reduced significantly. If your beneficiaries receive the inheritance directly, they cannot create the Trust themselves to access this tax saving and creditor protection; it must be done in your Will.

There are many technical details involved in using testamentary Trusts to reduce income tax for surviving beneficiaries. For example, unless the Trust is for a spouse, unrealized capital gains will be taxed immediately upon your death and then every 21 years while the Trust exists. The final distribution of the Trust property can be set out in your Will, to avoid the 21-year deemed disposition, in order to ensure the smooth succession of your property to your beneficiaries, tax free.

Your BMO Nesbitt Burns Investment Advisor can help introduce you to an estate planning professional who can review with you the possible benefits of using a testamentary Trust in your personal estate plan.

Please note: Some terms are capitalized for purposes of greater clarity in the context of this discussion only.

11/10-628

The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estate law. The comments contained herein are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.
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