Tax Planning Your Will: Part 1

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Testamentary trusts, those trusts which are created upon an individual's death pursuant to a Will, are most often utilized for practical purposes. The most common types of testamentary trusts are: "spousal trusts" (often used to protect assets for future generations and to maintain some control over the use of these assets during the surviving spouse's lifetime); "family trusts" (often used in conjunction with a spousal trust when the testator does not want to wait until the surviving spouse dies for the children to benefit from the estate); and "trusts for issue" (often used to ensure that the testator's issue do not receive their inheritances until a certain age). Where the testator has adult children, such children usually receive their inheritance outright without the use of a trust. However, the Will would still normally contain a trust for issue to deal with a grandchild inheriting from the testator's estate where an adult child predeceases the testator leaving children surviving him.

Surprisingly, our experience is that testamentary trusts are rarely used for tax purposes.

The fundamental tax advantage associated with testamentary trusts is that any income earned by the trust can be taxed within the trust at graduated rates. In this regard, the use of a single testamentary trust can result in approximately $20,000 less tax – in each year – on roughly the first $125,000 of income taxed therein.

Significant tax savings can be achieved where - rather than distributing an individual's estate outright or upon attaining a certain age, as is most commonly the case - inheritances are put into, or continue to be held in, trusts drafted specifically as tax-planning tools. Generally, these trusts provide sufficient flexibility for the individual to deal with the inheritance such that it is akin to paying the assets outright to the individual – only they provide an extra set of graduated rates while the assets remain in the trust. This is generally achieved by appointing the individual to act as the sole trustee of his trust, providing him with the unfettered discretion to use all of the trust funds for himself during his lifetime, the ability to determine how the trust funds shall be distributed upon his death, all the while also providing him with the ability to retain the funds in the trust in order to take advantage of the graduated rates. More details regarding the structuring of these trusts will be contained in Part 2 of this article.

By way of an extreme example, where an individual with a spouse and three children – each of whom, in turn, have three children – was otherwise planning to leave his entire estate outright to his spouse, the use of multiple testamentary trusts can result in potential tax savings as high as $500,000 in each year. These savings can be achieved by taking advantage of the graduated rates associated with a testamentary trust for each of the surviving spouse ($20,000), the three children ($60,000) and the nine grandchildren ($180,000), while also taking advantage of each child's and grandchild's graduated rates where such child or grandchild does not otherwise earn any income in the year ($240,000), where applicable. Upon the surviving spouse's death, the potential tax savings can increase to up to $720,000! While the surviving spouse's trust savings ($20,000) will be foregone, the surviving spouse could create an additional trust for each child and grandchild, resulting in up to an additional $240,000 of potential tax savings in each year ($20,000 per additional trust).

Not only does this extreme example require significant income-producing assets in order to maximize savings ($90 million, assuming a 5% rate of return, roughly half of which must be owned by each spouse), but the use of multiple trusts may not always be desirable (primarily because in order to achieve the result, a surviving spouse's inheritance will be significantly reduced). In fact, where the testamentary trust "strategy" is utilized, many individuals will choose to hold the entire estate in a single testamentary trust on the first spouse's death, for the sole benefit of the surviving spouse during her lifetime, in lieu of an outright distribution (requiring income-producing assets of only $2.5 million to achieve annual tax savings of roughly $20,000 during the surviving spouse's life). It is only upon the surviving spouse's death that most individuals opt to use multiple testamentary trusts for children and/or grandchildren.

In recent news, the new "top" marginal tax rate in Ontario has made the use of multiple testamentary trusts even more appealing as an additional $11,500 can be saved in each year where a trust earns $500,000 of income. While significant income-producing assets will be necessary to maximize those savings (i.e., $10 million per trust), the cost of not using such trusts has clearly gone up!

Finally, it must be noted that there are costs associated with this strategy, including (i) Wills becoming more complex and requiring additional time and effort; (ii) estates becoming increasingly difficult and more costly to administer; (iii) compliance costs increasing significantly; and (iv) the potential for fiduciary claims by contingent beneficiaries who feel aggrieved. The hope is, obviously, that the potential tax savings will outweigh these costs.

The second part of this article will discuss the structure of the tax-oriented testamentary trust and will appear in the fall Newsletter.