

Transfer your estate tax-efficiently

For families concerned about intergenerational wealth transfer, an updated Will with a testamentary trust provision is an indispensable tool. A testamentary trust is a type of trust established through your Will that enables you to give assets to your beneficiaries with certain conditions that you have specified, while providing them with income tax advantages.

In a trust, you specify an amount of money or other property to be held for a specified period for beneficiaries you have identified and on the terms directed by you. For example, you may wish to leave your children a portion of your estate, but you may feel that they should not receive their inheritance until they are old enough to manage it

responsibly. Through your Will you would direct your chosen trustees to hold and invest the inheritance in a trust for your children until they reach the age that you have specified. Alternatively, you can give your trustee full discretion on the amount and timing of trust distributions to the beneficiaries.

Testamentary trusts are generally created with assets passing through one's estate. Therefore, probate taxes (negligible in Alberta and Quebec) will likely have to be paid. However, there will be no probate tax for a properly structured testamentary trust funded with insurance proceeds.

One of the major benefits of establishing a testamentary trust is the annual income tax savings for the surviving beneficiaries. These income tax benefits are not available to beneficiaries who receive outright inheritances. Taxable income earned in a testamentary trust can be subject to the same graduated tax rates as an individual taxpayer. Since the income earned within a testamentary trust can be taxed on a separate tax return at graduated tax rates (although the basic exemption is not allowed), an income-splitting opportunity arises for each beneficiary.

Assume an adult child is in the top marginal tax bracket of approximately 46% (varies by province). Upon the parent's death, this child is expected to receive an outright inheritance of approximately \$500,000. Further assume that this inheritance will be invested by the child and will produce annual taxable income of 5% or \$25,000 per year. The following table compares the after-tax income that will be earned this way with the after-tax income that will be earned if the inheritance is transferred to a testamentary trust instead.



FAMILY WEALTH MANAGEMENT TIP

In addition to the tax benefits, there are many reasons why a testamentary trust may be advantageous. A testamentary trust provision in the Will can make sense in the following scenarios:

- › Individuals in second marriages
- › Disabled or minor beneficiaries
- › Parent is concerned about spendthrift beneficiaries
- › Parent is concerned about inheritance being accessed by son- or daughter-in-law
- › U.S. citizens
- › Beneficiaries are high-income earners or will receive a large inheritance

TESTAMENTARY TRUSTS

FIGURE 2

	Inheritance transferred to adult child outright	Inheritance transferred to testamentary trust*
Taxable income earned on inheritance	\$25,000	\$25,000
Tax payable	(\$11,500)	(\$5,500)
Trust tax return fees	\$0	(\$500)
After-tax income	\$13,500	\$19,000

* It is assumed trustee fees will not be charged

As you can see from Figure 2 above, the adult child enjoys an overall savings of \$5,500 per year (\$19,000 - \$13,500) by earning investment income through a testamentary trust.

If you intend to have your assets pass through your estate so they can fund a testamentary trust, then Joint Tenancy with Rights of Survivorship accounts (not applicable in Quebec) may not be appropriate, and you may also need to restructure beneficiary designations. Furthermore, if you are a high-income earner and you have elderly parents that you know will be providing you with an inheritance, consider speaking to your parents about the benefits of including a testamentary trust provision in their Will.

Speak to your advisor if you are interested in having a Will and estate review from an RBC estate planning specialist. Based on your situation, this specialist can provide Will and estate-planning recommendations such as the suitability of a testamentary trust, vacation property succession planning strategies, the benefits of a secondary Will to avoid probate tax on private company shares, and more.

For more information, ask your advisor for a copy of the article titled "Testamentary Trusts".

