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Death, Taxes and Testamentary Trusts

How Estate Planning Can Help

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Losing a loved one is bad enough, but losing large chunks of an inheritance at the same time can feel like cruel and unusual punishment. A bereaved family can find probate fees or capital gains tax eating up a large part of their loved one's estate.

Consider the following scenario: Mrs. Smith plans to leave what remains of her deceased husband's estate and her own to be divided equally between her two adult children, John and Jane. Assume the estate consists of the assets listed in Table 1.

Table 1. Smith Estate

Asset	Cost	Fair Market Value at Death
Home	$200,000	$400,000
Investment account	$200,000	$600,000
Private company shares	$100,000	$1,000,000
Total	$500,000	$2,000,000

On their mother's death, John and Jane each expect their share of the estate to be around $1 million. They are shocked to find that about $330,000 of the estate disappears in capital gains tax and probate fees. Here's why.

Under the *Income Tax Act*, a deceased person is deemed to have sold all property at fair market value immediately before death. With some exceptions, if the asset has appreciated in value, there will be a capital gain, of which 50% is reported as taxable income. In this scenario, if the home is the principal residence, it will be exempt from capital gains tax, but the investment account and the private company shares could attract about $300,000 in capital gains tax.

Probate fees or estate administration taxes vary from province to province. In Ontario, the probate fee rate is 0.5% for the first $50,000 of estate value and 1.5% thereafter. An estate worth $2 million would be subject to about $30,000 in probate fees.

Had the Smith family done some estate planning, the scenario could have been very different.

For example, a $750,000 capital gains exemption is available for capital gains on a qualifying small business. To qualify for the capital gains exemption, the business must meet a variety of different tests. With proper planning, the Smith business could be set up to qualify for the capital gains exemption, reducing capital gains by almost $175,000 in this example.

Had Mrs. Smith used the dual Will strategy, she may have been able to save approximately $15,000 in probate tax on the value of the private company shares. The dual Will strategy usually involves putting assets that require probate in one Will and those that may not require probate in a second Will. Other probate tax-saving strategies may also be available.

Mrs. Smith could also set up trusts for each of John and Jane in her Will. Trusts created in a Will are called testamentary trusts. They can earn income and file a separate tax return. Mrs. Smith may also include John's and Jane's family members as discretionary beneficiaries of each trust. The trustee can then decide annually how to allocate the income between the trust and the various discretionary beneficiaries of each trust, to take advantage of each tax payer's low tax bracket. This income-splitting strategy can provide considerable tax savings over the life of the trust.

Anyone contemplating such arrangements should obtain proper professional advice in advance. What works in one situation may not work in another. The lawyers in the Wills and Estates Group at Lawrences have significant experience helping families develop efficient and effective estate plans.

Michael Prsa chairs Lawrences' Wills and Estates Group. A member of the Society of Trusts and Estate Practitioners, Mike focuses his practice on estate planning, estate administration and estate litigation. He can be reached at (905) 452-6880 or mjprsa@lawrences.com.

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