# How Testamentary Trusts Can Enhance Your Estate Planning

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Traditional Will planning often provides for outright bequests to surviving beneficiaries, as opposed to the structuring of surviving *testamentary trusts* established for someone's heirs. A testamentary trust is a trust that comes into effect upon the passing of an individual.

It is common to see testamentary trusts used for estate and Will planning in situations where beneficiaries are disabled. Or, where there may be concerns regarding a beneficiary's future unrestricted access to funds under a direct bequest scenario. Testamentary trusts continue to work well in these situations. They serve as a way to provide structured funding needs and asset protection for certain beneficiaries who may not be able to manage this on their own.

It is now becoming more commonplace in estate and Will planning to extend testamentary trust planning to *all* beneficiaries. Such extensions occur through the use of controllable, fully discretionary trusts. Careful and well-thought-out structuring of discretionary trusts can provide significant tax and financial benefits to beneficiaries. These benefits can include: continued control and management over the estate assets received; flexible funding and distributions of annual cash flow to beneficiaries; and opportunities to provide for effective tax savings through income-splitting with multiple family members. Many of these benefits can be ongoing for several years – and can be quite substantial.

Typically, the trust will receive a distribution from a person's estate. The express intent is that these funds be held for the benefit of either single or multiple beneficiaries. These trusts will have a trustee appointed whose responsibility will be to manage these assets for the beneficiaries. Controllable, fully discretionary trusts are a unique form of trust wherein the acting trustee has the ability to distribute trust assets and income to specific beneficiaries as they so choose. This discretionary flexibility allows a trustee to manage and control the assets of the trust. It also lets the trustee manage the future tax implications of income distributions to beneficiaries in a tax-efficient manner.

We are seeing an increasing trend in the use of these trust structures in estate planning. They provide opportunities for flexible management of a family's financial assets and tax planning opportunities to access benefits – not only today, but also going forward long-term. Let's take a closer look at some of these potential benefits in a typical family context.

Our family consists of parents John and Nancy, and their three adult children, Paul, Susan and Cathy. The three adult kids all have children of their own. John and Nancy own all of their assets in joint tenancy. Under their current Wills, they are leaving everything to their survivors. Upon the passing of the last survivor of John and Nancy, they plan to equally distribute their remaining assets to separate discretionary trusts established for the benefit of each of their children and their families.

Each of these trusts would typically be structured as mirror images of one another. As a result, we now have three separate family trusts: the Paul Trust, the Susan Trust and the Cathy Trust.

Each trust fund would have Paul, Susan and Cathy appointed as the trustees for their respective family trust. Beneficiaries of the Paul Trust, for example, would include Paul and his spouse, plus their children and future grandchildren. The trusts for Susan and Cathy would each have a similar beneficiary structure. Having the trusts structured in this fashion allows each family to access the following benefits:

**Asset Management and Control –** It was the parents' intention to provide their adult children with full control over their respective inheritance, while giving them significant flexibility in managing and controlling the assets received. This goal has been achieved for Paul, Susan and Cathy. They have the power as trustees to make payments to themselves, or to any or none of their respective trust beneficiaries, as they so decide. Further, the trustees will have the ability to wind up their trusts in the future. At that point they can distribute assets either to themselves. Or, they can share the distribution of trust assets amongst the beneficiaries based on the trustee's discretionary powers.

On a future wind-up of the trust, proper structuring will allow for the distribution of trust assets on a tax-deferred basis. This will avoid any capital gains taxes being triggered. Suppose the initial trustee has passed away before wind-up and distribution of the trust assets. In that case, it is possible to put in place alternate mechanisms and conditions to be met in regards to future trust asset distributions. Structuring of the trusts would also include provisions to deal with appointment of a replacement trustee in the event that the initial trustee has passed away, or is unable to act in the capacity of trustee.

**Save Taxes through Family Income-Splitting –** *Income-splitting* is one of the cornerstones of income tax planning. Simply stated, income-splitting is a process of shifting and dividing income from the hands of one family member to another who will pay tax at a lower rate. This can produce significant tax savings. A discretionary testamentary trust is a terrific tool for splitting income.

Initial tax planning for the estate should consider the actual timing of distribution of the estate assets. Suppose distribution of the estate assets into separate beneficiary trusts is delayed. It may then be possible to have this income taxed in the estate as a separate taxpayer for the first three years. Assuming the estate meets certain conditions for tax purposes, it may also be possible for income earned to be taxed at lower marginal tax rates. This would reduce overall estate tax costs for up to three years.

Let's now move to the point where the funds are distributed from the estate to establish the family trust funds. Paul, Susan and Cathy will each be able to divide the annual income earned in their trust fund between themselves, their spouses, children or grandchildren, as they choose. This income-splitting opportunity can dramatically reduce the overall taxes payable by the family as a whole where beneficiaries have access to lower marginal tax rates on income reported by them. As there are no time limitations on family income-splitting, this strategy can also be continuously used to obtain tax savings every year into the future.

**Asset Protection for the Family Inheritance –** The assets in the family trust are not owned directly by any of the trust beneficiaries. Therefore, it is possible to provide future creditor protection over the trust assets. A future family inheritance can be protected from any potential claims or actions that may be taken by third-party creditors against any individual beneficiaries. Let's say beneficiaries carry on other business activities with potential creditor claims risk, or they are required to provide personal guarantees to lenders. Having these assets held in a trust fund can provide significant protection from future claims.

**Note:** Proper planning and structuring of your Will can offer substantial benefits to your family. Given the potential income tax and legal complexities regarding the structuring of your Will, we recommend you seek professional advice before you consider establishing discretionary testamentary trusts as part of your overall estate plan.

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