[How To Create A Tax-Efficient Will]

written by Rory Lodge | July 31, 2015

Every will has an unnamed beneficiary: the Canada Revenue Agency. And many heirs and beneficiaries are often surprised that their inheritance has dwindled considerably after the taxman's take. Luckily there are a number of strategies and tactics you can use to make your will tax efficient and to ensure your beneficiaries get the bulk of your estate, not the CRA.

Let's start with one of the most useful will-planning strategies.

The spousal trust

Under Canadian tax rules, you are deemed to have sold all of your assets immediately prior to your death. And if your assets have increased in value, your estate will be subject to capital gains tax. At least your beneficiaries get to inherit your assets with a bumped-up cost base.

But there's one important exception to the deemed capital gain rule: You can defer your death-tax exposure by making your spouse the beneficiary of your estate, or better still, by leaving your assets in a qualifying spousal trust. There is no election that your estate need make. It's an automatic deferral to the extent you leave assets to your spouse or a spousal trust.

Specifically, bequests to a spousal trust (or to your spouse outright) will not trigger capital gains tax on your death because the transfer of assets occurs on a tax-deferred basis. In this case, capital gains tax exposure will be triggered only on the death of the surviving spouse.

The bonus of a spousal trust over an outright gift to your spouse is that you can choose trustees to protect your spouse against poor financial decisions. You can also ensure that the surviving spouse will not be able to transfer assets to undesirable beneficiaries (for example, a decision to leave your assets to the new spouse in the case of remarriage).

Once your spouse passes away, the spousal trust would then provide for the assets to pass to the residual beneficiaries (e.g., your children).

But you must be certain that the spousal trust qualifies for the tax-deferred treatment; otherwise, no tax-deferred rollover upon your death will be available. Specifically, the spousal trust must meet the following requirements:

- The spouse is entitled to receive all of the income of the trust while he or she is alive.
- No other person (including kids) may receive or otherwise obtain the use of any income or capital of the trust.

Note also that even though no one else is allowed to receive the capital of the trust, this does not mean that the spouse is automatically entitled to it. In other words, as long as no other person received or obtains the use of the capital, the spousal trust will not be disqualified.

In order to make sure that you do not stray from these requirements, it's important to get legal help when drafting your will and specifically any clauses relating to a spousal trust.

For example, a condition allowing the trustees to lend funds to a relative could be interpreted as allowing someone other than the spouse to receive or obtain the use of the capital. It may be okay, however, to lend funds on commercial terms – but you should first check with your advisor.

A spousal trust can provide for certain testamentary debts to be paid, e.g., funeral expenses and income taxes payable for the year of death and prior years.

Testamentary trusts

Until 2014, "testamentary trusts" were an effective tax-planning tool, as they were were deemed to be "separate taxpayers," with access to graduated tax rates. You could leave assets in a testamentary trust for your kids, instead of giving them outright. This way, the kids could "income split" with the estate. This opportunity was even more lucrative because the estate could choose to declare and pay tax on its income, even though it is actually paid out to beneficiaries. And the more testamentary trusts you created in your will, the more you had access to the graduated tax rates.

However, legislation introduced in late 2014 changed all that. Beginning in January 2016, testamentary trusts will no longer benefit from graduated tax rates. In addition these trusts are no longer exempt from making tax installments or having an off-calendar year-end.

As a result, testamentary trusts will now be subject to a flat top-tax rate. The only exception to this new rule is that the estate can take advantage of the graduated tax rates for the first 36 months. But after that, the opportunity to income split disappears (there will still be access to graduated rates for testamentary trusts whose beneficiaries are individuals who are eligible for the federal Disability Tax Credit).

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