LEGAL NEWS & VIEWS

Protecting your Inheritance

3 Things That Should be Included in Parents' Wills

Most parents wish to leave an inheritance that will benefit their children to the greatest extent possible. If that inheritance is provided as an outright gift, e.g., a payment of money or a transfer of investments, it is too late to undertake certain tax planning or creditor protection strategies. These strategies can only be put in place at the time a Will is drawn.

This article outlines three will-planning strategies that can result in tax savings to beneficiaries, as well as help protect an inheritance from creditors and ex-spouses.

1) Tax savings through Testamentary Trusts

A "trust" is an interest in property held legally by one person (the trustee) for the benefit of another (the beneficiary). A "testamentary trust", is a trust established by the terms of a Will. Often testamentary trusts name a beneficiary the sole trustee of the trust, thus giving that beneficiary maximum control over the inheritance, including the right to wind-up the trust and transfer all of the property out of the trust for his or her own use or the use of his or her children.

From a tax perspective, the benefit in using a testamentary trust lies in the fact that the income from an inheritance does not have to be added to the beneficiary's employment or other income and be taxed at the beneficiary's highest marginal rate. Rather, it can be taxed in the trust separately at the trust's own graduated rate.

Suppose, for example, Greg inherits $500,000 from one of his parents and receives it as an outright payment. Suppose also that he receives interest of 5% per year on the inheritance, that is, $25,000. Each year, this $25,000 will be added to Greg's employment income of, say, $70,000, resulting in taxes on the income from the inheritance of $10,850.

If, instead, Greg's parent in his or her will had created a trust for Greg, the $25,000 of interest would be taxed in the trust separately each year, at a lower marginal rate, resulting in only $5,400 in taxes.

Thus, Greg would save $5,450 in taxes each and every year. (For a more detailed example involving a larger inheritance with annual tax savings of $11,900, go to http://www.ggfl.ca/docs/trust_testamentary.pdf.)

When a testamentary trust has several beneficiaries (grandchildren, for instance), further income tax savings are possible.

2) Creditor Proofing Through Testamentary Trusts

It is well known that incorporating a business provides some personal protection against creditors. Nevertheless, it is often necessary for a business owner to provide personal guarantees to lenders, especially when starting a business. As a director, a business owner can also be held liable for certain other corporate obligations.

Prudent business owners, therefore, protect their personal assets by reducing the number of assets they own in their own name.

An inheritance received by a person in business (whether the business is incorporated or not) may be protected from claims of creditors, if the inheritance is received through a testamentary trust. To maximize the creditor protection, the choice of trustees is critical. In particular, the business person should not be the sole trustee of the trust of which he or she is a beneficiary.

3) Protecting your inheritance in case of separation or divorce

The laws of Ontario generally provide that your spouse is not entitled to any inheritance you receive after the date of your marriage. These laws, however, do not adequately protect the growth of the inheritance, or assets purchased with inherited funds.

Therefore, there should be a clause in a parent's Will stating that not only the inheritance, but all growth and property acquired using the inheritance is protected from claims of a spouse in a divorce.

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These simple measures included in parents' Wills can help ensure that children and grandchildren (rather than the government, creditors or ex-spouses) will receive and retain more of parents' hard-earned money in years to come.

This article provides general information only and does not constitute legal or tax advice. It was prepared by Melanie McDonald and Joanna Ringrose. Melanie is a lawyer practicing in the areas of estate planning and estate administration with BrazeauSeller. LLP in Ottawa - www.brazeauseller.com.

Joanna is a lawyer in Oakville practicing in the areas of estate planning and estate administration. For inquiries, please contact Joanna at (905) 844 -5021

JOANNA J. RINGROSE
B.A.(HON.), M.A., LL.B., LL.M.
BARRISTER & SOLICITOR
(905) 844 -5021
RINGROSELAW@COGECO.CA
WWW.ESTATESLAWYER.CA

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HEATHER A. LAIDLAW
BARRISTER
905.337.9633
heatherlaidlaw@cogeco.ca
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