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Marmer Penner Inc. Newsletter

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Spousal Trust - How to Protect Your Assets and Lower Income Taxes

Couples commonly have wills that bequest all of their property to the surviving spouse after the death of the other. A concern may arise that, if the surviving spouse ever re-marries, all or some of the property that was intended to remain “in the family” may find its way into the hands of a stranger. Many individuals would like to protect the inheritance they intend to leave to their children. One such strategy might be to leave more property directly to their children as opposed to leaving it to the surviving spouse. The problems with this strategy are two-fold. First, under family law equalization obligations, leaving most of your property to your children may be challenged by the surviving spouse. Second, transfers to a spouse or former spouse can occur on a tax-free basis while transfers to your children will occur at fair market value meaning that capital gains, recaptured depreciation and business income may be triggered by the transfer.

A way to avoid these problems while still protecting the assets is by way of a spousal trust. Instead of naming your spouse as the beneficiary of your property, the will can name a trust for the benefit of your spouse as the beneficiary. The terms of the trust may be such that your spouse is the income beneficiary and your children are the capital beneficiaries. This entitles your spouse to enjoy use of the income for the remainder of his/her life without risking the capital which is reserved for the children.

A concern might be that while the income is expected to be sufficient to maintain the surviving spouse's lifestyle, what if costs suddenly escalate, perhaps due to medical needs, and there is insufficient income for the spouse? You may not want to create a situation where your spouse has to ask your children for additional funds. Instead, the trust can provide the surviving spouse with the right to encroach on capital in such circumstances subject to the trustees' approval. This takes the decision out of the hands of individuals with a biased interest.

In addition to the asset protection offered by the spousal trust, there are income tax advantages. Similar to tax rules discussed above, a transfer to a spousal trust has the tax-free advantages of a transfer to spouse or former spouse – that is, it occurs at cost triggering no taxable income. Even more valuable can be the income splitting advantages afforded by the trust's testamentary nature. There are two types of trusts – an *inter vivos* (meaning "in life") trust, which is created in the settlor's life and a testamentary trust, which is created on death, usually in the settlor's will. A spousal trust created by one spouse's will is a testamentary trust. Trusts are taxed at personal income tax rates. A major difference between these two types of trusts is that an inter vivos trust is taxed at the highest marginal rate on all of its income while a testamentary trust is taxed at graduated rates like an individual. That means, for example, that on $37,000 of income, a testamentary trust would pay about $7,400 of tax. If this income was taxed in your spouse's hands and he/she was already taxed in the highest bracket in Ontario, the tax would otherwise be over $17,100 resulting in about $9,700 of tax savings.

A significant concern of many surviving spouses is the sudden increase in income tax following one spouse's death. Two spouses each earning about $100,000 of retirement income might pay tax of about $25,000 each depending on the type of income. However, if one dies and the surviving spouse must report all $200,000 of income, most of the additional income is taxed at 46.4% resulting in much higher taxes on this same level of income because it is reported on just one tax return. Leaving half the income to be taxed in a testamentary trust instead can alleviate this tax problem by allowing the family to continue splitting income between two taxpayers. As can be seen, even if asset protection was not a primary concern, the use of a testamentary trust created for the benefit of your surviving spouse can be advantageous.

If you are planning to utilize the tax and asset protection afforded by a spousal trust, you should ensure your will is amended and that assets which you wish to transfer to the spousal trust are not held as "joint tenants with right of survivorship". Such ownership forces the property to be transferred directly to the joint tenant without passing through the intended trust.

Since there are many issues to be considered besides asset protection and income tax minimization, individuals should consult with an income tax and estate specialist.