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COMMENT

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Edition 279 – 2013

TESTAMENTARY TRUSTS IN THE SPOTLIGHT

The 2013 Federal Budget announced that the Department of Finance intends to conduct a review of the tax benefits associated with testamentary trusts. Like any planning technique, there are a number of tax and non-tax benefits to consider in utilizing a strategy. The notes in the budget announcement indicate that the government feels the preferred tax treatment afforded to testamentary trusts raises issues with respect to tax fairness and neutrality, when compared with other taxpayers. As well, they indicate concern with the perceived potential growth in the tax-motivated use of testamentary trusts and the impact on the tax base.

A testamentary trust is one that is established upon the death of an individual (the "testator"). A testator could consider using one or more testamentary trusts to accomplish specific objectives when distributing assets of his or her estate to each beneficiary or class of beneficiaries. The following is a collection of strategies that make use of a testamentary trust to accomplish the objectives of the testator.

1. *A testamentary trust is taxed based on the graduated (or "marginal") income tax rates available to individuals*. This means there is an income-splitting opportunity where some income is retained and taxed in the trust and some is distributed and taxed to the beneficiary. The testamentary trust effectively allows the surviving family to have one or more "extra taxpayers" to report some of the family's income at lower marginal rates and therefore lower the family's overall annual income tax liability.
2. *A testamentary trust could protect spendthrift beneficiaries from themselves*. The trust could be designed to pay out, from the income and capital of the trust at the discretion of the trustee, sufficient funds for the beneficiary to meet reasonable lifestyle needs. This allows the beneficiary to inherit a long-term allowance. Since the beneficiaries do not have unrestricted access to the capital, they are protected from themselves and cannot completely deplete the inheritance.
3. *A testamentary trust could hold the beneficiary's inheritance and put in place an appropriate investment manager that would take into consideration the needs of the beneficiary*. This strategy allows the testator to provide a beneficiary who is an inexperienced investor with professional investment management rather than leave it up to the beneficiary to invest the capital from the inheritance.
4. *A testamentary trust could be designed to motivate certain behaviours from the beneficiaries*. For example, the testator may feel that education is very important, so could design a trust to fund the education of the beneficiaries. Another example would be a testator who feels earning an income builds character, who could design a trust that pays a distribution based on the amount of income earned by the beneficiary. The testator should be aware, however, that there are legal barriers that may prevent the testator from controlling certain behaviours through the trust. Some conditions are outside of good public policy (for example, a provision that restricts marriage outside of a faith) and would be voided by the courts. As such, discussion with legal counsel in the establishment of the documentation can provide guidance on unique issues.
5. *A testamentary trust could be designed to provide income for a second spouse while ensuring the testator's wealth eventually passes to his or her children*. Many family situations involve a second marriage and children from the first marriage, leaving the testator with multiple obligations to his or her dependents. A trust could be designed to pay all of the income to the surviving second spouse, along with some access to capital to maintain lifestyle. Any capital remaining upon the second spouse's passing would be distributed to the children of the testator.
6. *A testamentary trust can be designed to stage the inheritance of the beneficiaries*. A beneficiary receiving a substantial amount of money all at once could face a steep learning curve with

respect to managing money, and could make investment or spending mistakes. Sometimes the beneficiary will not be able to recover from these missteps and the inheritance could be lost. A trust could be designed to pay a beneficiary's inheritance in stages, such as one-quarter at each of ages 25, 29, 33 and 37; this type of staged distribution provides the beneficiary with the opportunity to learn about money management throughout the distribution period, and minimizes the possibility of a major depletion of funds from an error.

Testamentary trusts are an integral element of each of the planning strategies outlined above to meet the testamentary wishes of the deceased and specific needs of the beneficiaries. Because of the breadth of needs and diversity of beneficiaries, testators will often need several testamentary trusts to implement their wishes. In these situations, the multiplication of testamentary trusts is based on needs and is not income-tax-motivated.

Testamentary trusts allow for effective planning in order to accomplish the deceased's testamentary wishes. It is hoped that as the Department of Finance completes its review of these trusts, they will appreciate their value and ensure testators have as much flexibility in the future as they do today.

I/R 8001.00, 2500.00

FIRST-TIME DONOR'S SUPER CREDIT

The 2013 Federal Budget proposes to introduce a temporary supplement to the existing tax credit for charitable donations by individuals. Named the First-Time Donor's Super Credit, the budget papers explain that the purpose of this new credit is to encourage those who have not made a charitable donation in the recent past to make a donation. The idea is to help kick-start a good habit.

The tax credit system for charitable donations is a method by which the government assists in the funding of charitable activities chosen by the public on a cost-sharing basis. If the activity is important enough for a taxpayer to support with a contribution, then the government shares in the donation by allowing that individual a tax credit. Canadians made $10.6 billion in financial donations to charitable and non-profit organizations in 2010, but the average was only $446 per donor.

Under the new proposals, first-time donors will get an extra 25% federal tax credit for cash donations of up to a maximum of $1,000 of donations made on or after March 21, 2013, up to December 31, 2017. This limited timeframe reflects the temporary nature of the credit. The addition of this new credit is projected to cost the government an average of $25 million annually for each of the next five years.

The following chart shows how the 25% credit will be added to the charitable credit thresholds currently in place.

	Cash donation of $400	Cash donation of $1,000	Cash donation of $1,500
15% tax credit on first $200	$30	$30	$30
29% tax credit on amount above $200	$58	$232	$377
25% super credit on amounts up to $1,000	$100	$250	$250*
Total tax credits	$188	$512	$657
Note: *The donation eligible for the super credit is capped at a maximum of $1,000			

In essence, the total credit for a first-time donor will be 40% on the first $200, plus 54% for amounts between $200 and $1,000. It should be noted that the first-time donor will also be eligible for provincial tax credits in addition to the federal credits shown above.

For purposes of this new tax credit, an individual is considered a first-time donor if neither the individual nor the individual's spouse or common-law partner have claimed any charitable donations in any taxation year after 2007. This means the super credit must be shared by couples, and if either spouse has claimed any charitable amount, even $20 or $50, subsequent to 2007, this will negate the couple's access to the new super-credit.

The credit is only available for cash donations, which means that donations in kind such as shares are not eligible for the first-time donor super credit.

First-time donors who wish to make a donation should contribute what they can but be conscious of the timing of their donation, where possible, in order to maximize the value of the new super-credit.

I/R 1600.00

PORTABLE LIFE INSURANCE

Life insurance can be a key element in an individual's estate plan. This is a universal fact, and many individuals in countries around the world buy life insurance to protect their families and pass wealth on to the next generation.

As globalization continues to expand its reach and we see increased economic interdependence between nations, many individuals find themselves relocating from one country to another. Such a move may take place because of a personal employment opportunity, a relocation to be closer to family or perhaps simply exploring a new lifestyle. As people move between countries, the individuals and their family members need to recalibrate the family's financial plan to reflect the local situation and their own changing circumstances.

Life insurance purchased in one country can migrate with the owner to another country. However, as an immigrant to Canada, the new resident must comply with Canadian tax legislation. Canada taxes based on residency; therefore, it taxes anyone resident in Canada based on their worldwide income. Canada's tax system has a broad definition of what constitutes a "life insurance policy." In general terms, where a product provides for a death benefit or constitutes an annuity arrangement, there is a strong indication that it could be a life insurance policy for Canadian tax purposes.

Life insurance purchased in another country will be subject to the Canadian tax laws. This means the foreign insurance policy might be considered exempt (not taxed on an annual basis) or non-exempt (taxed on an annual basis), as defined in the Income Tax Act. Unfortunately, these rules are extremely complex and cannot be easily understood or assessed by a consumer. Therefore, in situations where the life insurance policy has significant cash value buildup, it may become important for the individual to retain the professional services of a consulting actuary to opine on the policy's exempt status. During the course of engagement, the consulting actuary could also determine the policy's adjusted cost basis under Canadian tax law, which could be useful for certain policy transactions that the individual may contemplate in the future and that could have Canadian tax consequences.

As an added complexity, it is important to note that all Canadian tax measurements, including the exempt test, would need to be performed in Canadian currency. Unfortunately, this means that significant fluctuations in the value of the currency in which the policy is denominated could put a policy "off-side" and non-exempt because of year-to-year increases in Canadian dollar equivalents.

It should be noted that since Canada taxes its residents on worldwide income, the individual could be exposed to taxation on foreign life insurance policies held in foreign trusts or foreign corporations, depending on the circumstances. It is important for individuals resident in Canada to fully report these types of arrangements. As such, a fulsome discussion about the individual's complete insurance portfolio can be helpful, to identify issues that on the surface may appear irrelevant but could have tax consequences.

Understanding the potential tax consequences associated with a life insurance policy when an individual relocates to Canada will help minimize unexpected surprises and ensure the long term viability of the individual's estate plan in which the insurance plays a role.

I/R 4450.08, 2500.22

TIPS FOR STUDENTS WHO WANT TO SAVE

With spring underway, university and college students who are enjoying a well-deserved break from their studies will soon be joined by their high school counterparts. In the summer, students earn money that will help them get through the next school year. For many, this money is the difference between a financially stressful school year and one where the student can focus on "job one," which is to do well academically.

The concept of saving for the future is something that does not come naturally to everyone. It takes discipline and practice to save, just like it does to kick a habit, to diet, or to change a particular behaviour. Parents can influence a student's behaviour by acting as a positive role model. Allowing a child to observe financial self-discipline helps students understand value and offers encouragement. And sharing tips and ideas about how to make saving a regular part of one's lifestyle can prove valuable.

Set a weekly savings target: Determine, in advance, a reasonable amount of spending money needed each week during the summer. Then, translate that dollar amount into a percentage of the individual's regular pay cheque. For example, consider the situation where the individual feels they have spending needs over the summer months of $100 per week, while their weekly pay cheque amounts to about $400. In this case, the goal would be to set 25% of the weekly pay aside for spending and target 75% as the amount to be saved weekly. Moving 75% of the weekly pay into a separate savings account helps isolate the savings using a clear, easy-to-understand target. A student who is 18 or older may want to consider using a Tax-Free Savings Account (TFSA) for this purpose.

Minimize taxes withheld: Students have tuition, education and textbook credits that reduce their overall tax burden. Completing and filing a TD1 (2013 Personal Tax Credits Return) form with the summer employer will reduce the amount of tax withheld at source and increase the cashflow available to the student over the summer months.

Use cash as the preferred method of payment: While careful use and management of credit cards can help build a strong credit score, it can create a false sense of available funds. A savings strategy could involve setting the credit card aside for the summer and utilizing cash (or an electronic equivalent) as the preferred method of payment. Cash helps establish clear boundaries, particularly when it comes to discretionary choices, and lowers the temptation to overspend. By utilizing only cash, or limiting electronic payments (such as debit card transactions) to a "spending" amount that is predefined and kept separate from the student's savings account, it becomes perfectly clear the daily latte or new pair of shoes comes with trade-offs. Keep the credit card handy for true non-discretionary emergencies.

Avoid temptation: As the balance in the savings account builds, for some individuals it can become increasingly tempting to put one's hand into the "cookie-jar." By setting an overall stretch goal as to the balance the individual would like to accumulate over a specified period, it helps as an added incentive to avoid dipping unnecessarily into the funds.

Awards and bursaries: While an award or bursary is not truly a savings goal, these sources of funds are available at many post-secondary institutions and can help supplement the savings that a student achieves over the summer months. Because these resources are often overlooked by many, students should be sure to actively research the availability of these additional sources of potential funds and complete the necessary applications. While academic performance may be a consideration for some of the awards or bursaries, others may not be tied to academic performance. Either way, by researching and understanding what sources of financial support may be available, students can potentially supplement their summer savings.

Making financial ends meet throughout a school year often depends on how successful a student is with a summer savings plan. Moral support and financial guidance by parents can add to a successful outcome.

I/R 5601.00

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Publication Agreement # 40069004

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