A PRIMER ON WILL AND ESTATE PLANNING

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Introduction

Basic Will planning – often done by young couples early in their careers and before they have accumulated significant assets – usually focuses on the protection of dependents and providing for their needs if the breadwinner passes away. While these remain important considerations in planning your Will throughout your lifetime, there comes a point in life when the other inevitability – "taxes" – should be taken into account. After all, one of the primary goals of proper Will and estate planning should be to protect your assets from the government and ensure, to the greatest extent possible, that your assets are preserved for your beneficiaries.

Estate planning is the term used to describe this planning process. This article is intended to focus on some of the income tax planning considerations and strategies that can be part of an overall estate plan. The following information is of a general nature only and is not intended to be guidance or advice on any particular situation. Always ensure you receive your own professional advice before proceeding with any of the planning described in this article.

Before beginning, it is important to understand some aspects of the basic structure of Canadian tax laws. In Canada, there are no "estate" taxes *per se*, but rather we have a tax system designed to tax the increase in the value of assets at the time of death. In general, tax rules impose a "deemed sale" at current market values at the time of a person's death. These taxes can be deferred when assets pass to a spouse (or a qualifying "spouse trust"), so there is not much concern if there is a surviving spouse. But, eventually, even a surviving spouse will pass away and assets start to pass between generations. It's at this point that the tax aspect of estate planning becomes a major concern – especially if there are significant assets within an estate with significant untaxed growth in value (capital gains).

The Importance of Wills in Proper Tax and Estate Planning

While the importance of having a Will is widely understood, many Wills may miss essential tax and estate planning opportunities. Proper Will planning means spending extra time understanding your family's financial structure which means you can't expect to pay "bargain basement" fees for the right advice. Also, more sophisticated financial situations may require specialized tax expertise – from your lawyer, your accountant and your financial advisors. The following are a few Will and tax planning strategies which might be considered:

"Estate Splitting" and Multiple Trusts

Because an estate is treated as a separate person for tax purposes, it can take advantage of low tax brackets, just like an individual. This means that, in effect, beneficiaries can "income split" with the estate. This "estate split" opportunity has been made even more effective due to a rule that an estate can choose to pay tax on the income even though it is actually payable or distributed to beneficiaries. In fact, this opportunity can be taken a giant-step further by establishing multiple trusts in the estate, each of which is potentially eligible for low tax rates. There is an anti-avoidance tax rule whereby the Minister can designate multiple trusts as being a single trust for tax purposes if the trusts are not carefully structured; however, the CCRA has not been quick to use this power.

Probate Planning — Multiple Wills

In Ontario, and at least some other provinces, the Estate Administration Tax ("EAT" – formerly known as "probate fees"), can be reduced through the use of multiple Wills. This tax is collected at the time that a Will is submitted to the Court to be "proved" – a process called obtaining a "Certificate of Appointment of Estate Trustee", and formerly called obtaining "probate". This process is required when the executor's – or now the Estate Trustee's – authority to deal with the assets under the Will must be formally proven and is usually not necessary when there are not significant assets. The Will to be probated would include only assets which require Court-approved probate to be transferred to the beneficiaries; a second Will, which

would not be probated, would deal with the testator's other assets. This technique can be enhanced through the use of “trustee” corporations to hold title to assets which need to be probated.

Recent income tax changes have opened up a second avenue for probate and other planning — so-called alter ego and joint partner trusts, available to individuals aged 65 or over. These are effective at reducing probate and, in addition, may provide other advantages, for example, unlike a probated Will, they are not on public record. However, these trusts may have their own set of problems. For example, it is not possible to “estate split” with these trusts, since they are not eligible for low tax rates as would be the case with a true estate.

In Ontario, the EAT is calculated at the rate of 1.5% of the value of the assets of the estate, with a reduction in value only for mortgage debts. While this tax should not be ignored, some commonly-used probate planning techniques can often do more harm than good. A case in point is placing assets in joint tenancy. While this may avoid the EAT, it can have other harmful consequences, including the following:

- “Estate splitting” advantages, which might otherwise be available when the asset passes by Will, are lost on income-earning property held in joint tenancy. That's because property in joint tenancy passes outside of the deceased person’s estate. This lost opportunity may outweigh the reduction in EAT achieved;

- Creditor and marital considerations – if you transfer assets to an adult child in joint tenancy and your child runs into creditor problems or goes through a marriage breakdown, the assets now held in joint tenancy will be subjected to the claims of creditors and/or former spouses;

- Where a joint tenancy is created between persons other than spouses, there is a partial deemed sale of the asset — e.g., if between a parent and child, there will be a deemed sale of one-half of the asset. This may trigger an immediate tax liability, notably if the asset has appreciated in value (and the taxes will be payable immediately even though there has been no “sale” to pay the taxes!). If the asset is income earning, the transferee will generally be liable for one-half of the tax on that income in the future (presumably, though, the transferee would be entitled to receive one-half of the income to defray the tax). If the asset transferred is a principal residence, part of the exemption may be lost, e.g., if the transferee already has a principal residence, or does not ordinarily live in the transferred residence.

RRSPs/RRIFs — Financially Dependent Children and Grandchildren

Although a spouse has traditionally been thought of as the obvious beneficiary of an RRSP (or RRIF) in terms of tax deferral, another alternative is to designate a “financially dependent” child or grandchild. The RRSP inheritance would be taxed in the hands of such a qualifying beneficiary, who will probably be in a lower tax bracket than the deceased person or the surviving spouse. What's more, financially dependent children and grandchildren are able to purchase a special annuity that will enable them to defer tax while minors (indefinitely if dependent because of mental or physical illness). A number of restrictions to this strategy have now been removed; for example, this strategy can now be pursued even if there is a surviving spouse. The CCRA's policy is that if the beneficiary's income does not exceed the basic personal exemption, he or she is considered to be financially dependent; otherwise, the beneficiary must demonstrate financial dependency. In general, in order to avoid the Ontario EAT, the designation should be made in the RRSP contract itself, rather than by Will.

Same-sex Partners

Some individuals may want to amend their Wills in view of the recent tax changes treating qualifying same-sex couples on similar footing to couples of the opposite sex. Although these changes are generally something of a mixed blessing, in the estate planning area they are beneficial, as they generally allow for tax deferral where assets are left to a same-sex partner. For example, there is no longer capital gains tax exposure when appreciated assets pass to a same-sex spouse; similarly, it is possible to defer tax on RRSPs that are left to a same-sex spouse.

Planning After Death

In certain situations involving private corporations, it may be advisable to undertake certain corporate reorganizations after assets pass to another generation; otherwise there may be a “double tax” exposure — once because of the deemed-sale-on-death rule, and a second time when the corporation's assets themselves are sold or distributed. The terms of the Will as well as the selection of executors (Estate Trustees) may be important in terms of carrying out this “post mortem” tax planning. For example, where the Will utilizes a “spouse trust”, the spouse trust should provide for a “lagged distribution” on the death of the surviving spouse, rather than an immediate distribution to the residual beneficiaries. Where executors are also beneficiaries, it may be prudent to appoint at least two executors, to simplify post-mortem tax planning. The Will should also provide powers necessary to undertake such post-mortem planning, including making tax elections, redeeming shares, effecting reorganizations, and so on.

Spouse Trusts

A spousal trust is a trust set up through a Will where, rather than passing assets directly to a spouse, the assets are held in a trust exclusively for the benefit of the spouse. A spousal trust is a unique kind of trust that can be created by a Will, and the trust is entitled to the same deferral of tax as if the assets were passed directly to the spouse. However there are certain other advantages. For example, if the surviving spouse is already earning sufficient income apart from the estate assets to put him or her in a high marginal tax bracket, the income earned on the assets held within the trust can be taxed at the trust’s lower marginal rates of tax and separate from the spouse’s higher marginal rate of tax. Where a spouse trust is used, in order to qualify for tax deferral on death, it must provide that the spouse is entitled to receive all of the income of the trust that arises before the spouse's death, and no person other the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust. The CCRA has recently indicated that a trust would not qualify for the deferral if its terms permit the lending of trust property to a person (other than the spouse) on terms more favourable than that which would otherwise be available to that person commercially — even if the trustees did not make such a loan. So, it would be prudent for the terms of the trust to prohibit such loans, for example, by restricting loans to commercial terms (including a market rate of interest, appropriate security and a reasonable repayment schedule).

Estate Freezes

Estate freezes can be an important and essential part of estate planning for financially-successful individuals and their families.

An estate freeze refers to the isolation of the *future* growth in value of a business or investment in the hands of a subsequent generation – usually the children. This limits capital gains and other tax exposure that normally occurs when assets pass from parents to children, either during their lifetime or on death. The most common form of estate freeze involves the transfer of assets to a corporation or the reorganization of an existing corporation. This is often combined with the use of a family trust. The parent(s) receive shares whose future growth in value is eliminated or limited (“Freeze Shares”) and which enable the parent(s) to retain control of the corporation itself. The future growth in the value of the corporation accrues instead to the children – or the trust set up for the children (which holds the “Growth Shares”). Although the Growth Shares could be held directly by children, the family trust can be put in place to provide an additional degree of control and protection against mismanagement by the children, who become beneficiaries of the trust. In most cases, a “discretionary trust” is used, which in effect, enables the trustees to determine who gets what and when.

An estate freeze should be implemented where the underlying assets are not intended to be sold during the parents' lifetime. So, most freezes involve family businesses or long-term real estate holdings. There's no point, for example, in freezing shares that are subject to a mandatory buy/sell on death, nor is it usually advisable to freeze investments which are likely to be “tax paid” on death, for example, portfolio shareholdings which are likely to be sold during the parents' lifetime, most mutual funds, or interest-bearing investments. In fact, transferring these into a corporation often leads to immediate tax liability and other complications. Nor is a freeze advisable if the children are very young. The reason is that, where a family trust is used to hold the Growth Shares, to avoid capital gains tax, the shares must be distributed to the beneficiaries prior to the 21st anniversary of the trust.

Freeze structures should be reviewed from time to time. The following are some areas that may be addressed.

21-year planning

The most important time to review an estate freeze is before its 21st anniversary. As mentioned earlier, if assets are not distributed from the trust prior to this anniversary, capital gains or other tax exposure may arise in the trust, as tax rules call for a deemed sale of assets that are held by the trust at this point. In addition, owing to fairly recent tax changes, trustees are now jointly and severally liable for taxes incurred by the trust as a result of missing the 21-year deadline. So, trusts previously set up that are approaching their 21st anniversary should now be reviewed.

Investment income

Another overlooked tax planning opportunity relates to the build-up of investment income by corporations. This income can result in special corporate “surplus accounts” (notably capital dividend or refundable dividend tax on hand accounts) that can be used to reduce the death tax exposure to parents holding Freeze Shares. The build up of investment income may allow the Freeze Shares to be redeemed on a tax-effective basis during the parent(s) lifetime. If this can be done, it may avoid complex reorganizations after death.

Family Ties

Freeze structures should also be reviewed where there are changes to family circumstances, particularly where the freeze has been effected through a discretionary-type family trust. For example, if some but not all children have become involved in the family business, an unequal distribution from the trust may be advisable, especially if the parents have assets outside of the corporation with which they can compensate non-participating children. However, trustees, especially other than the parents themselves, should remember the fact that, under trust law, they owe a "fiduciary duty" to the beneficiaries (even where the trust calls for wide discretion). It may therefore be advisable for the person who establishes the trust to write a “letter of wishes” to the trustees specifying how he or she wants the trust's assets to be distributed. The letter of wishes, while not legally binding on the trustees, may nonetheless put them in a more defensible position with respect to distributions from the trust.

In addition, an effective estate plan should take into consideration family law provisions, particularly those dealing with the division of property in the event of a marriage breakdown. These provisions can potentially affect the parent undertaking the freeze and the children beneficiaries.

Corporate-owned Life Insurance

Periodic review of an estate freeze may be necessary given ongoing changes to tax laws. One example is the life insurance area, particularly the advantages of corporate-owned life insurance, which can not only fund death tax liability, but, if properly structured, can actually reduce it. For many years, it was possible to obtain a dollar-for-dollar reduction of capital gains tax on death with corporate-owned insurance. In April of 1995, these rules were changed, but with “grandfathering” for certain pre-existing arrangements (these arrangements should be reviewed carefully in order to ensure that grandfathering status continues to apply). After this, the general rule was that corporate-owned insurance arrangements would only result in a 25% reduction in capital gains death tax exposure. But as a by-product of changes to the capital gains inclusion rate, the death-tax reduction for structured corporate-owned insurance arrangements can increase back up to 50%. This means that, with capital gains tax itself at less than 25%, a well-structured corporate-owned insurance arrangement can cut the death tax to the 12% range. (Besides grandfathered insurance arrangements, one instance in which a dollar-for-dollar death tax reduction may still be available is when a buy-sell agreement is structured so that shares nonetheless pass to a surviving spouse, e.g., using a structure where holding companies enter into the buy-sell.)

Decline in Value

In some cases, an estate freeze might be implemented, only to find that the value of the corporation has declined. In these circumstances, it would obviously be beneficial to undertake a new freeze at a lower

value in order to decrease the death tax exposure. Although the CCRA had previously indicated that this may give rise to taxable benefits problems, a few years ago it reconsidered its position, so that the ability to re-freeze at a lower value is now open.

Reversionary Trust Rules

Especially for older estate freezes, a concern arises where the so-called "reversionary trust rules" have ever applied to the trust. Basically speaking, these rules are designed to operate where a contributor to the trust retains too many "strings" on it, that is, where he or she can dictate or veto who gets what, or simply take back his or her contribution. Such trusts are now subject to a dangerous tax trap: the shares or other assets in the trust can be distributed on a tax-deferred basis only to the contributor while he or she is alive (such a distribution, would usually jeopardize the freeze). A distribution to other beneficiaries during this period triggers a deemed disposition at fair market value. This rule is a particular problem for older estate freezes. The rule came into effect in 1988 and there was no "grandfathering" for older trusts. A couple of other points to keep in mind:

- The rules potentially apply to any contributor to the trust with too many "strings" attached, not necessarily the "Settlor" who formally establishes the trust. So it may be advisable to review the mechanics of the freeze itself as well as subsequent transactions, especially for an older freeze.

- The reversionary trust rules may come into effect owing to a change of circumstances. One example is where the contributor started out as one of several trustees but other trustees resign or pass away. Even if the contributor is one of two trustees, he or she would then have a veto and the rules would kick into effect.

As you can see, the subject of estate planning can be difficult and detailed yet can reap large rewards if approached properly. As with all things involving an interpretation of legal rules and procedures, the best advice is to seek your own professional advice – early and often – to ensure that you, your family and your assets are properly protected!