

TAXING TIMES



ESTATE PLANNING DECEMBER 2004

NOTICE TO READER

The following commentary has been prepared by Parker Garber & Chesney, LLP based on information available to the public on the date of publishing.

Readers are cautioned that this commentary is informational only and that any issues specific to the reader's needs be addressed with the appropriate tax professional.

The reader is cautioned that this document is not meant to provide advice specific to the reader's particular situation and that advice cannot be given in such a manner.

ESTATE PLANNING

As the baby boom generation gets older the concern about estate planning grows. According to a recent CMHC study it is estimated that boomers will inherit more than \$12 billion over the next 10 years. The concern for this generation is the amount of this wealth that will be retained as opposed to the amount paid away in taxes and probate fees. When considering the various aspects of estate or succession planning many issues must be addressed including:

- ✓ Wills
- ✓ Income Tax
- ✓ Probate
- ✓ RRSP and Insurance Designations
- ✓ Family Law Considerations
- ✓ Business Successions
- ✓ Use of Trusts
- ✓ U.S. Tax Considerations

WILLS

In the past most people prepared a simple will leaving everything to their spouse. Most couples prepared what we call mirror-image wills in which all assets were left to the surviving spouse, and on the death of the survivor, everything went to the children or other named beneficiaries. Complex family relationships such as divorces, second families, common-law and same-sex relationships and children born outside of a marriage are just a few of the issues that must be considered in preparing a will.

MARRIAGE

It is a little known fact that a will is generally revoked as the result of a marriage that takes place after the will has been prepared unless the will was prepared in anticipation of the marriage.

As well, most people are unaware that common-law spouses and partners do not have the same rights as legally married spouses when one of the partners dies. In particular, there are no equalization rights available to unmarried spouses/partners and no entitlement for someone who dies without a will.

DIVORCE

Generally, a bequest will be revoked under law when a divorce is finalized. However, a separation does not revoke a bequest. Separated spouses should review their wills to ensure that bequests are updated.



INCOME TAX

Under Canadian tax law there is no estate, gift or inheritance tax. Taxpayers are deemed to have sold all of their assets at fair market value at the time of death and would incur a tax on the resulting capital gains. Any assets left to a spouse would pass at its tax cost unless the deceased's representative elects to recognize the gain. This would normally be done to take advantage of the capital gains exemption or to offset capital losses of the deceased.

RRSP and RRIF funds transferred from a deceased to a spouse's RRSP (including a common-law spouse) are free of tax. If the beneficiary is a minor dependant then the tax on the transfer of funds is deferred until they reach the age of majority. Otherwise, where a non-spouse beneficiary exists, the deceased will be taxed on the proceeds from the RRSP. In order for the tax-free transfer to take place the beneficiary should be named in the RRSP contract.

Life insurance proceeds are not normally taxable unless the policy includes a taxable investment component.

PROBATE

Probate planning has become quite popular lately but we have seen many attempts that have resulted in substantial tax problems that are greater than the probate cost. Some taxpayers have arranged for their wills to be probated in Alberta (requiring an Alberta-based executor or administrator) where the maximum probate fee is \$400 for estates over \$250,000. Ontario rates for estates over \$50,000 is \$250 plus 1.5% of the amount over \$50,000. New Brunswick rates for estates greater than \$20,000 are \$100 plus 0.5% of the amount over \$20,000. Nova Scotia rates for estates greater than \$100,000 are \$820 plus 1.385% for amounts over \$100,000. Quebec has no probate fee but wills in Quebec are subject to a different regime under Civil Code.

In reducing expected probate fees some taxpayers have transferred assets to family members, either in joint name or otherwise. These transfers can result in adverse tax consequences that include the ongoing taxation of income earned from these assets in the hands of the named owners and the possible unintended triggering of a deemed disposal of appreciated assets that could result in a premature tax on the gains. It can also produce unexpected exposure to creditors or loss of control of assets that have been transferred, either in whole or in part, to family members.

One matter that can and should be addressed is the fact that not all assets require probate. Usually probate is only needed to facilitate the transfer of registered assets such as real estate. In addition banks and brokerages will not normally transfer assets into the name of a beneficiary or beneficiaries without proof of probate unless the accounts were held in joint name with rights of



survivorship. Many other assets such as share in and advances to private corporations as well as personal property like art, jewellery and collectibles do not require probate. However, if the deceased has only one will, the assets cannot be divided and this may result in paying substantial probate fees for no relevant purpose. In order to avoid this unnecessary cost, it is legally acceptable to have more than one will. A person could create a will for probate that would only address assets that require probate and a second will dealing with the assets not requiring probate. This could result in a substantial savings on probate fees.

Another solution available for an individual age 65 or more is the use of trusts (see below).

RRSP and INSURANCE DESIGNATIONS

It is important that individuals review their RRSP and insurance contracts to ensure that they have named specific beneficiaries. Without a named beneficiary the proceeds from these contracts must be included in the probate filing.

FAMILY LAW CONSIDERATIONS

Many individuals do not consider the impact of the Family Law Act (Ontario) (FLA) and similar legislation in other jurisdictions when creating their wills or in probate planning. Generally speaking, FLA requires that the parties of the marriage must establish their net assets value at the time of marriage and again at the time of separation. The net increase in value must be equalized between the spouses. While bequests under a will are not normally included in the calculation of family assets of the beneficiary, if the bequest or the proceeds from the disposal of a bequest is used to purchase a family asset such as a house or cottage then the funds lose their exempt designation and fall under FLA. The same holds true if the assets are mingled with other family assets or put into joint name with a spouse.

With the increase in concerns that parents may have concerning the longevity of relationships it may be prudent to use what is often referred to as a Family Law Clause in the will that would restrict the ability of a beneficiary's former spouse to make claims against the estate.

Legal advice should be sought in all matters related to family law.

Other issues that should be addressed include:

MARRIAGE CONTRACTS

Commonly called "Prenuptial Agreements" these agreements can be either pre- or post-marriage and are available to both married and common-law



relationships. The agreement is often used in a second marriage/relationship and usually addresses issues of children from prior relationships. A will created in conjunction with a marriage contract may take on two forms: (a) make a distribution from the estate which is a simple and straight-forward method to allow the estate to be wound-up quickly or (b) create a testamentary trust that allows the executors to maintain control but has more cost. (see trusts below).

Marriage contracts can be used for both estate planning and for the protection and retention of assets in the event of a marriage or relationship breakdown.

BUSINESS SUCCESSION

One of the most important and most ignored areas of estate planning is business succession. This usually entails an operating business in which one or more of the children of the deceased may be working. While many parents want their children to take over the family business, this is not always logical or practical. Some children may not want to work in the business while others may not be capable. In the circumstance where no one is readily available or likely to be able to continue the operations over a long term the family must be in the position to either introduce competent management to run the business or be able to expeditiously find a buyer for the business.

A part of estate planning not often addressed is direction from the principal on what the best course of action may be. In addition, there are many circumstances where one of the children may be a likely candidate to continue operating the business. In this situation there should be consideration as to how to divide assets on the assumption that the desired result is an equal division of value. If the child wishing to continue operating the business is to have control of the business, the remaining beneficiaries must get other assets that would result in an even-handed distribution.

This may be achieved through the allocation of RRSP funds, other investment assets, personal property or life insurance. It is very important however, that all of the tax implications are considered. If one child is left \$1 million of RRSP funds, one left with shares of a private company worth \$1 million and the third child left with \$1 million of life insurance proceeds, the resulting tax will leave three distinctly different asset values. In addition, the tax consequences of the deceased must be dealt with and consideration must be given to making financial provisions for any tax liability.

USE of TRUSTS

Most taxpayers have heard of the use of trusts as an estate planning tool. In fact, trusts have become the mainstay of estate planning. Trusts allow the grantor/settler of the trust to establish rules and maintain control over the use of



the assets while providing income or capital to beneficiaries on a fixed or discretionary basis.

Trusts can pay tax on the income received by the trust and then add the net income to capital. Subsequent distributions from capital are tax-free to Canadian residents. In the alternative, the trust may allocate the income to the beneficiaries so that they pay the tax at their personal rates. In this case, generally, the source of income of a trust retains its identity when distributed on a taxable basis. (i.e. dividend income in a trust will be paid to beneficiaries as dividends, capital gains will remain capital gains so that the tax treatment in the hands of the beneficiary is the same as if the income had been received directly.) There are a number of different kinds of trust that must be defined as part of any discussion.

TESTAMENTARY TRUSTS

A testamentary trust is created by the death of a taxpayer. This kind of trust is considered a separate person under the Income Tax Act and is subject to most of the same tax rules as living taxpayers. Most important, the same tax rates and brackets apply to testamentary trusts as to individual taxpayers thereby allowing for income-splitting at a reduced tax cost.

SPOUSAL TRUSTS

Generally created by a will, this testamentary trust, if properly constituted, allows the assets of the deceased to pass to the benefit of the spouse on a tax-free basis if they are a resident of Canada. The income of the trust would be available to the spouse and the executors may determine the amounts to be taxed in the hands of the trust and the spouse. The spouse may or may not have the ability to encroach on capital. Upon the death of the survivor spouse, the capital would pass to the beneficiaries of the estate of the first deceased spouse.

OTHER TESTAMENTARY TRUSTS

A will can create a trust or series of trusts for the benefit of beneficiaries. This is usually used in the case of minor beneficiaries or other beneficiaries where the deceased feels that the executors should maintain control over the assets and distributions. Income may be taxed in the hands of the trust or allocated to the beneficiaries and there may also be powers of encroachment on the capital. Each trust is taxed as a separate person so that it may be possible to create a substantial tax-saving regime through a well-constructed will. A will for a parent with three children could effectively set up a trust for each child, a trust for the spouse and a trust for all three children, thus creating five separate taxpayers created by the trust in addition to the four surviving individuals. This would allow the use of nine distinct low-tax-bracket taxpayers.



INSURANCE TRUSTS

Another testamentary trust, this one should be created in the insurance contract and usually is used for minor beneficiaries.

INTER-VIVOS TRUSTS

These trusts are created by contract, other than a will, and are otherwise known as living trusts. An inter-vivos trust is taxed at full tax rates, in other words, at the highest marginal rate.

FAMILY TRUSTS

These somewhat maligned estate-planning vehicles have been in decline since the introduction of the “kiddie tax” in 2000. However, tax-effective distributions to children who are not minors can still make use of the trust for the funding of post-secondary education and other financial needs. As inter-vivos trusts there is a disincentive to retain income in this kind of trust. They are very useful for estate-freezes that allow taxpayers to skip one generation or more of tax but it is important to address such issues as control when establishing these trusts.

ALTER-EGO AND JOINT PARTNER TRUSTS

These two inter-vivos trusts have become popular in the last few years as an alternative to avoid probate fees. As with other probate-planning attempts, it is important to ensure that the “probate tail doesn’t wag the tax dog”. These trusts are meant to be only for the benefit of the settlor who contributes their assets into the trust or the spouse/partner of that person while they are alive. On death, the assets would pass to the beneficiaries named in the trust.

The contribution of the assets to these trusts in this situation can only be made by taxpayers age 65 or older and they would continue to include all income from the trust on their personal tax return. The transfer of assets would not trigger a disposition for income tax purposes. These trusts should be creditor-proof.

The problem is that since these are inter-vivos trusts, no testamentary trusts can be created on the death of the settlor so that the beneficiaries can make use of the low tax brackets.

INSURANCE

Insurance is probably the most common element of estate planning that can provide a low-cost method of funding business successions or tax liabilities created on death. A discussion on this topic is too complex to be addressed in this forum and we suggest that readers should consult with their insurance professionals in conjunction with their accounting and legal advisors. Also to be



considered in establishing an insurance plan are such strategies as buy-sell agreements, cross-insurance and first or last-to-die coverage.

U.S. TAX CONSIDERATIONS

No tax or estate planning paper is complete without addressing the concerns and complexities of U.S. taxes. Unlike Canada, the U.S. has an estate tax regime that encompasses a wide range of taxpayers that may not realize they have liability.

ELIGIBILITY

All U.S. citizens are subject to tax, including income, estate and gift tax, in the U.S. no matter where they reside. In addition, non-U.S. citizens holding Green Cards are deemed residents of the U.S. for income tax purposes and are subject to all of the taxes as if they were citizens. Children of U.S. citizens are normally considered U.S. citizens.

Non-resident aliens may have U.S. estate tax liability if they have certain types of U.S. situs assets. These assets include (but are not limited to):

- U.S. real estate (i.e. Florida condos);
- Shares in or debts from U.S. corporations, even if traded on non-U.S. stock exchanges;
- RRSP assets in U.S. assets;
- U.S. bank accounts connected to a U.S. business;
- U.S. Money Market Funds;
- IRAs, profit-sharing or pension plans of U.S. companies, even if employment is in Canada;
- Deferred compensation plans from U.S. companies;
- Stock options in U.S. companies;
- Shares in Canadian corporations exchangeable for shares in U.S. corporations;
- Interests in U.S. Limited Partnerships or Limited Liability Corporations if the underlying assets are U.S. based.

VACATION PROPERTIES (THE FLORIDA CONDO PLAN)

The problem for most Canadians is that we all own some form of the above-listed assets. While tax is not usually payable on many of these items during our lifetime, there is an estate tax issue in the U.S. on death. The issue becomes more complicated if one spouse is a U.S. citizen.

To alleviate these problems, in the past many people used single-purpose corporations to hold title to a vacation property in the U.S. CRA has accepted this method of ownership in the past because of the conflict between our tax on death and U.S. estate tax. Now that the Canada – U.S. Tax Treaty has dealt with that



issue, on a limited basis, CRA will no longer accept the use of single-purpose corporations after 2004 except for properties already held in that manner. In addition, the IRS has never accepted this method but they have not appeared to pursue it.

In the future, Canadians with personal-use property in the U.S. will be best advised to consider using a partnership or a U.S.-based trust to hold the real estate. This should minimize or even eliminate the estate tax problem.

An excellent planning consideration is to obtain a non-recourse loan against the property. This loan will reduce the property value for estate tax purposes on a dollar-for-dollar basis but it **must** be non-recourse. If the property is already fully-paid, you can borrow as much as 70% of the value against the property and, if you reinvest the funds, the interest is tax deductible in Canada and you have also successfully reduced the estate tax. (see example below on page 9)

INVESTMENT PORTFOLIOS

For those with substantial investments in the U.S., other than vacation property, a holding company would likely make the most sense in order to avoid estate tax. The transfer to the corporation can be completed on a tax-free basis in Canada and there is no U.S. tax unless it is real estate.

U.S. ESTATE TAX RATES

The U.S. has a progressive tax rate bracket and an exemption system in place for the calculation of U.S. estate tax.

Year	Exemption	Maximum Tax Rate *
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	no exemption – estate tax repealed	
2011	\$1,000,000	55%



What the above graph means is that unless the U.S. Congress addresses the estate tax issue before 2011 the estate tax regime will regress to the position it was at in 2001.

* This rate is the maximum rate including any state estate tax. The combined Federal and state tax cannot exceed this rate.

EXEMPTIONS

The misconception that most Canadians have about the amount of exemption is that the full amounts, as listed above, are available to them. That is not the way that the math works. The exemption is based on a pro-ration of the world-wide assets of the deceased.

Example: (all amounts in US\$)

A taxpayer dies in 2005 with U.S. situs assets with a value of \$1,000,000 and a world-wide estate of \$5,000,000. The gross tax on \$1,000,000 is \$345,800. The tax credit on the exemption is $1,000,000/5,000,000 \times \$555,800$ or \$111,160. The U.S. estate tax is \$234,640.

In the same example, assume that the deceased had taken a non-recourse mortgage of \$700,000. The interest on the loan, assuming it was invested to earn income such as interest or dividends, rents etc., would be deductible. The value of the U.S. estate would be \$300,000 but the world-wide estate would remain the same. The gross tax on the \$300,000 would be \$87,800. The tax credit on the exemption is $300,000/5,000,000 \times \$555,800$ or \$33,348. The U.S. estate tax is \$54,452. This represents a tax savings of \$180,188.

Some of the U.S. tax will be available for an offsetting credit in Canada but it would be prudent to make efforts to minimize or eliminate the tax because of the pro-ration.

POST-MORTEM PLANNING

U.S. tax law does allow for post-mortem planning, the most common of which is the establishment of a qualifying domestic trust (QDOT). This is available in the circumstance where a U.S. taxpayer resident in Canada dies and the spouse is not a U.S. citizen.

SUMMARY

Dealing with these issues requires a delicate balancing of legal and tax issues along with securing the desired results. While this paper has tried to deal with as



many of the more common issues as possible, in a generalized document such as this, we cannot address all options or issues that may result in contrary planning considerations. This document is meant only to address certain matters in such a way that the reader would be made aware of the need to make inquiries of their professional advisors for a detailed plan and implementation.

