soundchoices

Retiresmart™

TAX-EFFICIENT TRANSITIONS

ESTATE PLANNING

SYNOPSIS: WEALTH PROTECTION STRATEGIES

If you have accumulated assets during your lifetime, you likely will want to ensure that wealth transitions cost effectively. Managing the details for tax filings maximizes the power of strategies, laid in place earlier in life, and keeps your assets intact for heirs. Your advisor can help tax-efficient transfers of assets by assembling adjusted cost bases for personal returns, and by showing you how to use trusts, particularly if you have high net worth.

INTRODUCTION TO ESTATE PLANNING

Estate planning should be approached openly with your financial advisor and several crucial conversations that must take place in the family. The first should be a discussion about whether an estate plan exists. The following are questions your advisor might ask you.

Do you have an estate plan?

You should have a will, a power of attorney, and a medical directive.

A will disposes of the your property when you pass away. A power of attorney appoints someone to handle your financial decision-making and affairs if you lose the capacity to do so on your own. A medical directive, also referred to as a living will, or a power of attorney for the person or personal directive, is a document that appoints someone to handle your personal and medical decision making and affairs if you lose the ability to manage on your own.

Is the current estate plan up to date?

You may already have an estate plan, but is it up to date? There are several important touch points to consider; for example:

- Are the people you have named under powers of attorney still willing to serve?
- Are they still the right people for the job?

The same questions can be asked about the people you have named as executors or estate trustees, and the persons named as decision-makers under the medical directive. You should check with the people involved to renew their commitments to serving in those roles. The accountant who had been willing to serve as your executor may not be willing to serve after he or she has retired.

You will need to update when there are significant changes in your life. If you answer yes to any of the following you should discuss with your advisor:

- Have any life changes intervened to render the will dated or demand changes to it?
- Have you married or divorced since the date of the last will?
- Was the will made before any children?
- Have you moved from one province to another since the will was made?
- Does the will attempt to give away assets that you no longer own?

A positive response to any of these questions amount to a life change that warrants a re-examination of your will.

Regardless of whether significant changes have occurred, a regular review is always a good idea. Lawyers typically recommend that you review your estate plan every few years. A review every five years is generally considered to be adequate.

What are you doing after work?®

Action plan: Should special planning be considered?

The vast majority of estate plans include a simple will. For a husband and wife, that typically involves serving as each other's executor, and leaving the whole of their estate each to the other as the survivor. When the second one passes away, his or her will divides the estate into equal shares among the children the couple has had together. If the children are young, their inheritances are typically postponed to some later age, perhaps age 30, when the children are expected to have gained the financial security and understanding to deal with the capital.

Both members of the couple also sign a basic power of attorney and basic medical directive as part of the plan. The will document is roughly four to six pages long. For many families a simple will is appropriate. If a couple has a combined net worth of $600,000 and have had two healthy children together, there is little need for more complexity or a longer will.

For many families though, this is not enough. Some families are confronted with circumstances that demand that they implement or at least consider more sophisticated solutions.

The list below sets out some situations where this might be true:

- **Blended families** – Imagine someone who has remarried, after having two children from a former relationship, both now adult. He passes away with a simple will in place, leaving everything to a new wife. She is stepmother to the adult children but is free to make her own will however she likes. What if she remarries? What if she has a child of her own? What if she has a dispute with his children? If she makes a will 20 years later, will she include his children? This is one of the most common ways in which children are disinherited. It is avoidable. Agreements can be signed under which both spouses promise to leave some or all of the wealth to the children. Spousal trusts can be used to provide income for the spouse while preserving capital for the children. More advanced structures such as joint partner trusts or estate freezes can be brought back into play. Life insurance products are a natural fit in this scenario, creating a 'second estate' to guarantee a payout for the children when their parent dies.
- **High net worth** – An individual with high net worth has opportunities to reduce income taxes for their heirs. A testamentary trust can be structured under their will to hold the inheritance. The trust is a separate taxpayer, and files a separate tax return taking advantage of a separate set of graduated rates. This is an income splitting strategy. Some strategies can be used to multiply the number of trusts in play. A couple with two children and a combined net worth of $5,000,000 might expect to establish a series of trusts positioned to save the children annual income taxes of $40,000 or more utilizing what is sometimes referred to a 'stepping stone' or 'spring-boarding' structure.

  Probate avoidance is an issue for wealthy clients who live or own land in jurisdictions with high rate probate fees such as Ontario and British Columbia, and even for clients who live in mid-range rate jurisdictions such as Manitoba and Saskatchewan. Multiple wills strategies can be used to reduce fees on shares in closely held family corporations. Joint ownership and gifting strategies are well-established mechanisms in the effort to avoid probate fees when a person passes away. Alter ego trusts and other types of trusts can be employed to further reduce probate.

  Wealthy families are motivated by protection issues as much as by tax avoidance issues. The use of various trusts can help.
- **Disabled heir** – Disabled heirs often need special estate planning. First, if a mental disability is involved, the heir may not be able to administer the wealth they receive. A trust or annuity is often employed. Second, the inheritance might result in the heir being discontinued from government income support or programming that is subject to a financial eligibility threshold. A fully discretionary form of trust, sometimes referred to as a 'Henson Trust', is often used to overcome that difficulty. Third, registered disability savings plans have to be coordinated with other tools in use. Fourth, special provisions of the *Income Tax Act* now allow a rollover of registered investments in favour of a disabled family member or a 'lifetime benefit trust' for the disabled heir.
- **U.S. and other foreign connections** – Families may have children across the globe and this must be considered in estate planning. Again, specialized wills can be used to exclude the inherited assets from estate or inheritance taxes when the heir passes away, using special planning measures to reduce or avoid them.

- **Family business or family farm** – Capital gains are triggered when a person passes away in Canada. While it is possible to defer the resulting capital gains taxes by transferring the asset to a spouse or common-law partner, that only delays the day on which the capital gains will be triggered. For farm families or families with a family business run through a private corporation, it can be a significant problem. Farm families are often asset heavy. The shares in the family company represent the majority of their wealth and have a nominal cost base. These families do not plan on selling the farm, or the family business, they want to pass it on to the children. Capital gains can interfere with that dream unless properly managed. In both cases a $750,000 capital gains exemption is available (proposed increase to $800,000 in 2014). Corporations have to be kept pure to take advantage of this exemption. Freeze strategies are also available to multiply access to the capital gains exemption to multiple family members. A rollover is available for farm property that exceeds the exemption amounts. Life insurance often has to be put in place.
- **Recreational real estate** – Recreational real estate attracts capital gains. For a family with property in the U.S., regardless of any other U.S. connections, it can trigger exposure to U.S. estate tax. For a family that owns more than one property in more than one province, it creates the need to account for probate fees separately on a province by province basis. A British Columbia property needs a BC compliant probate avoidance strategy. The principal residence exemption needs to be taken into account and employed at each stage to maximum advantage. Joint ownership, early transfers, and cottage trusts are sometimes employed.

USE OF TRUSTS IN ESTATE AND TAX PLANNING

Trusts can be a very useful tool in estate and tax planning.

An inheritance held inside a trust offers a protected pool of capital for the heir. The heir can marry and divorce and exclude the wealth comprising their inheritance from consideration in any ensuing divorce settlement.

In some provinces, the child can be the sole trustee of a trust established for the child's benefit and still expect to benefit from the sought-after protection. In other provinces, a panel of trustees may be advisable to secure the protection. In other provinces still, the protection is only partial, and growth may be shareable.

Trusts can also protect inheritances against creditors the heirs might have. Further, trusts funded by life insurance placed on the life of the individual can create an inheritance protected from the creditors of the individual's estate when the individual passes away.

Inheritances can be withheld under the terms of the person's will until the child attains a responsible age. Trusts can extend over the entire life of the child, and outside trusteeship and money management can be put in place. That kind of solution might be used if the child is mentally disabled or suffers from drug addictions. Portions of inheritances can be aimed at grandchildren, skipping a generation that might make mistakes in financial judgement if given a chance to do so.

Trusts: Income tax reduction strategies

Testamentary trusts are often used as income tax reduction strategies. If you have high net worth opportunities to reduce income taxes for your heirs. A testamentary trust can be structured under your will to hold the inheritance. The trust is a separate taxpayer, and files a separate tax return taking advantage of a separate set of graduated rates.

This is an income splitting strategy. The net tax savings per year, per trust, can be expected to range from $2,000 to as much as $10,000. An inheritance of $500,000 can be invested and generate $3,000 in annual income tax savings. An inheritance of $1,200,000 can be invested and generate $10,000 or $12,000 in annual tax savings per beneficiary. Those are rough rule of thumb, based on assumptions including a 4% rate of income on capital, and children with outside income of their own (results can vary, depending on your own personal circumstances).

Income splitting using a spousal testamentary trust –
The use of a testamentary spousal trust was discussed earlier as a mechanism to ensure that children would inherit in a blended family setting. They are used even more commonly as an income splitting measure designed to reduce income taxes payable by a surviving spouse on income generated on assets inherited from their spouse after their spouse has passed away.

Trusts and blended families. When a trust is used in a blended family, outside trustees are used to oversee the capital and barriers are built to make it clear that the capital is reserved for the children. Where a spousal trust is used for tax planning purposes, the surviving spouse can be named as the sole trustee of the trust, and the trust can include the discretion to remove capital at the spouse's behest for the spouse's support and benefit.

The trust qualifies for a rollover of capital assets without triggering gains as long as two conditions are met. First, no other person can be entitled to capital during the lifetime of the surviving spouse – the surviving spouse does not have to be entitled to receive the capital, but no one else can be.

Second, the surviving spouse has to be entitled to all of the income generated in the trust. Usually there is some wording in the trust will that states all of the income shall be paid to the spouse each year. Even though the income is, in fact, paid to the spouse each year, it can still be taxed on the tax return filed by the spousal trust to take advantage of the income splitting power of the spousal trust as a qualifying testamentary trust.

Testamentary trusts for children and other heirs – If a person has two children and at least $400,000 or $500,000 to leave each of them as an inheritance, they may wish to establish a series of testamentary trusts in his or her will as vehicles to hold the children's inheritances.

Capital gains are paid on the assets before they pass into the testamentary trusts for the children. There is no rollover, unlike with a spousal trust. If the child is of a responsible age, the child can be the sole trustee of a trust that allows free access to the child, and any grandchildren through that child. That allows for further income splitting.

As an example, a person with an estate of $3,000,000 and two children can, through the use of the right will, create a testamentary trust for each of the two children and save as much as $20,000 in taxes on an annual basis for the family after he or she is gone. The savings can be higher if grandchildren are involved.

The trust has to be carefully structured. If the child is to serve as sole trustee over a fully discretionary trust of the character described above, the trust must contain a provision, put in the will by the parent, directing the persons to receive the contents of the trust if the child dies at a time when the trust is still operating and holding assets.

Spring-boarding strategies – When drafting wills for a couple with children, it is possible to create not one trust per child but two. This is sometimes called a spring-boarding or stepping stone strategy. Here is how it works:

Lets look at an example where the wife in a couple dies first, she had set up a testamentary spousal trust in their will for the benefit of the husband. It might hold the contents of her registered investment portfolio and $500,000 in life insurance proceeds payable at her death. Those assets will be invested and held in the trust for her husband's benefit for the rest of his life.

When the husband dies, the wealth that remains in his trust at the time of his death will be divided into two shares and transferred into two new trusts, half and half. One of those trusts is for the first child and the second is for the second child. This is still governed by the will of the wife. The assets in those trusts originated with the wife.

The husband's will then kicks in and operates on the assets in his ownership at his death. The husband's will, like the wife's, divides the assets into two shares and nestles one into each of two trusts for the two children. That structure kicks out a total of four trusts, a pair for each child, each qualifying as a separate tax-payer and accessing a separate set of graduated rates. The total tax savings could be as much as $40,000 per year for the family after both husband and wife have died.

Trusts built to save taxes can only be drafted with the help of a tax professional. The wrong clause, or the wrong wording in the right one, will strip the structure of any tax savings. You need the right team to build and plan a tax-efficient transfer or your estate.

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