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ESTATE PLANNING

We hope that the following will assist you in understanding some of the basics for estate planning designed to minimize taxation. This is not meant to be a complete or exhaustive text on all legal rights and obligations which may arise in connection with this topic which is complicated and is unique for each individual or family situation. Please consult with a lawyer, accountant and financial planner before entering into any estate plan. The information presented has been updated to February, 2014. Please bear in mind that tax rules change frequently.

TAXATION ON DEATH

On death two types of tax are triggered, namely, income taxes and Estate Administration Tax (probate fees).

Income taxes charged on death include:

- capital gains on all property owned by the deceased which has increased in value since the time it was purchased, including investments, real estate, business assets and such personal items as collections. The principal residence exemption applies;
- adding to income, the remainder in the deceased's RRSP or RRIF, subject to a rollover in favour of a spouse or dependent child or grandchild; and,
- tax on income earned but not yet collected (declared but unpaid dividends from public or private corporations or vacation pay outstanding)

In addition to income tax, the Ontario government charges an Estate Administration Tax (commonly known as "probate fees") of 0.5% on first $50,000.00 and 1.5% on balance of the value of the deceased's estate. There is no exemption for principal residence or property left to a spouse or child. See the note on Estate Tax Administration enforcement at the end of this paper.

Tax planning designed to reduce or avoid tax altogether but don't be short sighted such as giving property away or to trust so as to avoid having a will thus missing the opportunities which may arise such as creation of testamentary trusts.

Tax planning is unique to everybody. There is no such thing as one plan that fits all. Everyone has different assets, different income, different needs while they are alive and different wishes as to how their family members are to be treated after death.

Simple planning items:

1. Designate a spouse or a financially dependent child or grandchild as a beneficiary of an RRSP or RRIF. This results in a transfer of that plan to those beneficiaries tax free. Note that minor children (currently under 18) cannot receive the proceeds and it will be necessary to appoint a trustee for them, under a properly structured and worded trust.

2. Designate beneficiaries on insurance policies so as to avoid having the proceeds added to estate and subject to Estate Administration Tax (probate fees). Trusts can be created so that the proceeds are not immediately distributed but are held in trust until distributed in accordance with the trust document. See below.

3. Hold assets (house, investments) as joint tenants or on joint account with right of survivorship. There is no advantage while alive, and *Income Tax Act* attribution rules will prohibit splitting income but it is easy to track contributions for purpose of allocating income for tax purposes. <u>If the joint tenants are spouses</u>, there is no deemed capital gain but rather the assets "roll over" to the spouse for their original cost.

   The disadvantage of adding an owner is that the additional owner may have a say in how the asset is disposed of, and in the case of land, no transfer or mortgage can take place without all joint tenants signing. **When transferring property to another person as a joint tenant it is important that the transferor specify, in writing, whether he or she is giving the property to the joint tenant for that person's benefit only (i.e. as a gift) or whether the transfer is being made for estate planning or other purposes and that the joint tenant is receiving the property not only for himself or herself but also on behalf of others.**

More Sophisticated Planning Items

1. **Corporate Estate Freezes.** Used by owners of businesses or other private corporations. Common shares (the shares which own the "growth" of the assets) can be exchanged for preferred shares. These do not share in future growth but may entitle the holder to some dividend income and which almost always entitle the owner to voting control. If elections are made and filed under the *Income Tax Act*, the exchange of shares is made without immediate tax consequences New common shares are issued to trusts, spouses, children or other beneficiaries. The result is that the owner of the business no longer shares in future growth of the value of the business and his or her value is therefore "frozen". Advantages are from an income tax standpoint to the effect that capital gains are minimized and from an estate administration tax standpoint in that only the value of the preferred shares (the "frozen" value) is included in calculations.

2. **Family Trusts.** Used by those who do not own businesses or assets within a corporation. These have to be set up carefully. A transfer of existing assets to a trust <u>does</u> result in a "disposition" being made and capital gains tax being payable. Therefore set up this type of trust with securities having no capital gains (or losses) or with cash.

New assets or investments can be purchased by the trust and anyone can lend money to such a trust.

These trusts have limited use with minor children or spouses as there are tax rules against income splitting ("Attribution Rules"). If a loan is being made, proper interest, at least at the rate prescribed under the *Income Tax Act*, must be charged and paid or the income that the trust earns could be attributed to the lender. To the extent that the Trustees pay any of the income of the Trust to or for the benefit of the beneficiaries (e.g. school tuition, caregivers, summer camp, clothing, travel, extra-curricular expenses), such amounts will be reported as income of the beneficiary for the year. Any amount deducted by the Trust as being paid or payable to a beneficiary is included in the beneficiary's income and, subject to special split income rules governing certain income received by minors, is taxable at his or her personal tax rates. Dividends and capital gains would retain their original character when flowed through the Trust so that a beneficiary is entitled to the gross up and tax treatment of dividends and to claim the capital gains deduction. A tax return may therefore have to be filed by each beneficiary, even though the beneficiary may have no other income in the year.

The trust is regarded as a separate individual for tax purposes but does <u>not</u> have the advantage of paying tax at a graduated rate, as does a testamentary trust as noted below. The trust can provide for income to be distributed annually, particularly to beneficiaries who have low incomes. The trust is deemed to realize all capital gains every 21 years, and therefore pay taxes on the gains, with some exceptions.

3. **ALTER EGO / JOINT PARTNER TRUST.** These are not useful for any income tax savings but used to avoid estate administration tax (probate fees). Since 2001 the *Income Tax Act* has provided for *alter ego trusts* and *joint partner trusts* which are specific tax planning vehicles for single or married (including common-law) seniors. Such trusts can be created by individuals who are over 65 and must provide that all of the income is to be paid to or on behalf of the person who created the trust (for the alter ego trust) or for that person or his or her spouse or both (for the joint partner trust) and that no other person can have the use of any of the income or capital of the trust. There is no disposition and therefore no capital gains tax on any transfer of property to such a trust and no deemed disposition after 21 years. The distribution of property from such a trust is not subject to any estate administration tax or associated fees and if the person establishing the trust appoints other trustees, those people can manage the trust property if the person who established the trust becomes incapacitated. There are income tax disadvantages in terms of charitable donations from the trust at the time of the Settlor's death. If this type of trust is utilized it is important that the bank, investment advisor or others holding accounts are notified and the account ownership formally changed. Otherwise the account holder may not recognize the trust after the Settlor's death and may require probate.

4. **Charitable Donation of Securities on Death.** Publicly traded shares, options, bonds, mutual fund units and other securities, land or valuable art works or collections which are given to a charity are eligible for special tax treatment. Normally, when these types of items are disposed of (sold or given away or deemed to be disposed of as a result of the owner's death) the owner will realize a capital gain (increase in value from the initial cost of the item) and must include one half of the capital gain in reporting income for a given tax year. However if given to a charity (or to an amateur athletic association, or to a designated university or charity outside of Canada, or to the federal or a provincial government), the capital gain is not added to income but the donor gets the full market value of the security as a charitable receipt. The amount not required to reduce current year income can be carried forward for five years. The amount of the gift given in the year of death (including a gift under a will) can be deducted against 100% of current year income (the limit while the donor is alive is 75%) and, any excess can be carried back for one year and a tax refund can therefore be claimed. Beginning in 2016, the trustee of the deceased individual's estate will be able to allocate the available donation among any of: (i) the taxation year of the estate in which the donation is made, or, (ii) an earlier taxation year of the estate, or, (iii) the last two taxation years of the individual. Therefore, a person may wish to consider structuring his or her will to provide for a charitable donation in order to reduce some of the tax consequences of death.

5. **Charitable Remainder Trust.** Giving money on death does not give a person any tax relief while alive. While an individual may have charitable intentions, such person may not be able to afford the loss of investment income he or she would suffer by giving away money away while alive. To help the charity and help the donor by getting a tax receipt and keep the income, a *charitable remainder trust* can be established.

   The donor arranges with a charity to give an amount of capital to a newly established trust which is administered by trustees the donor chooses. The charity may or may not insist on one of its representatives being a trustee. The trustees invest the money and give the donor the income while he or she is alive and then on death the charity gets the capital. The individual gets a tax receipt for the present day value of the amount put into the trust and can use that tax receipt as a deduction against income in the year of the transfer to the trust and five subsequent years. That means that an actuary will determine today's value of a gift the charity will not receive until the donor's death and is based on life expectancy tables. Obviously for an older donor, the tax receipt is a larger percentage of the amount paid to the trust. The charitable remainder trust assets do not form part of the Estate for tax or probate purposes, and are therefore not taxed on death. Furthermore, they will not be subject to claims of heirs or creditors. The charity will have immediate use of the money after death without waiting.

   These may be somewhat difficult to establish as many charities are not familiar with the concept or do not have the administration to handle it. If a donor finds a cooperative charity, such as one which is a united way or community type of umbrella organization, or a bank private giving foundation, the donor can usually get them to agree to give some of the money after death to other charities. All such charities must be registered under *Income Tax Act*.

6. **TESTAMENTARY TRUST.** An often overlooked tax planning device is a testamentary trust established under will. This means that money is not distributed immediately but rather held and invested and distributed at a later date. These types of trusts are unique for tax purposes in that they are taxed in the same manner as an individual and have the same graduated tax rates. This can result in a tax saving of several thousand dollars per year as both a beneficiary and the trust would have the advantage of graduated tax rates on their income. Separate trusts can be established for each family member so that separate trusts can be established by a husband and by a wife for their children, each one being taxed separately. Such trusts are particularly useful if a beneficiary does not need the capital and can benefit from it being invested.

Unfortunately, the government has determined that these trusts are not being used for the original purpose intended and too much income tax is being lost. Therefore, the 2014 federal budget has brought about changes so that, beginning in 2016, testamentary trusts will no longer benefit from preferred tax rates and will no longer receive special treatment under a number of other related tax rules for an indefinite time period. Like *inter vivos* trusts, the top tax rate will payable on all income <u>except</u> for the first 36 months after the date of death, when graduated tax rates will apply to an estate that is a testamentary trust. If the estate remains in existence for more than 36 months, it will become subject to the highest marginal tax rate for all income retained in the trust after that time period. An exception is that if the testamentary trust is established for the benefit of an individual who qualifies for the Disability Tax Credit, the trust will continue to benefit from graduated tax rates.

Where testamentary trusts and estates previously had a taxation year-end based on the date of death of the individual, all trusts will use a calendar year-end beginning in December 31, 2015.

These types of trusts will continue to be a viable planning tool for estates and family wealth preservation in Canada. The structure can provide the additional benefits of increased asset protection, control and support of disadvantaged beneficiaries, sprinkling of income to beneficiaries with lower tax rates and protection against spendthrift or otherwise irresponsible beneficiaries.

A spousal testamentary trust, which permits only a surviving spouse to get income or capital during his or her lifetime can be used to roll over capital gains. As noted, the sole beneficiary must be a spouse and administrative clauses cannot be drawn so as to permit others to get capital before death of the spouse. These are usually drawn in conjunction with a family trust to last for at least three years to permit carry back of capital losses in accordance with *Income Tax Act*.

Also, a testamentary trust can be created for a number of beneficiaries, such as children and grandchildren and the trustee can be given authority to pay income on a discretionary basis ("sprinkle") to those family members. The trustee could pay income to those who have minimal incomes, such as younger children or students. A will can provide that on the death of named beneficiaries, such as spouse or children, the trust could be wound up and capital paid to grandchildren. Giving the money to a spouse or child outright on the expectation that they would create their own trust would not have the tax savings effect of a testamentary trust.

7. **TRUSTS FOR THE DISABLED.** For special circumstances, trusts can be created for a disabled person designed to ensure that support under the Ontario Disability Support Program does not terminate. These are called "Henson trusts" and can be very useful in allowing money to be set aside to be used to provide extra comforts and pleasures for the disabled person without jeopardizing the person's entitlement to income support. Often, the amount available to be left by the testator in a Henson trust would not be sufficient to provide full support to the beneficiary if income support under the ODSPA were not available. However, because of the nature of a Henson trust there is potential for abuse. Since the trust is fully discretionary and the beneficiary has no enforceable entitlement, there is the potential for an inappropriate trustee to refuse to make payments from the trust to the disabled person and merely to accumulate the income in favour of the residuary beneficiaries. If a testator chooses to provide benefits for a beneficiary by way of a Henson trust, the choice of trustees is of crucial importance in order to be assured that the funds will be managed and used in a responsible manner. As noted above, whether or not created as "Henson trusts" testamentary trusts for disabled persons enjoy a tax advantage in the form of a graduated tax rate and ability to split income for disabled persons which was not removed by the 2014 budget measures.

Something else to consider is a Registered Disability Savings Plan (RDSP) which is a long term savings plan that can be opened on behalf of a person who is disabled before their 59th birthday. Earnings in the plan accumulate tax free until the money is taken out. There is no limit on how much can be contributed each year, but there is a lifetime contribution limit of $200,000. The Government of Canada will provide a matching grant of up to $3,500.00 per year to an overall maximum of $70,000.00 until the end of the year in which the beneficiary turns 49. Having an RDSP does not affect a person's entitlement under the Ontario Disability Support Plan (ODSP)

8. **INSURANCE TRUSTS -** A person who owns and is the insured under a life insurance policy may make a declaration that appoints a trustee to receive the insurance proceeds for the benefit of another, the terms of the trust imposed on the insurance proceeds will be established by means of the declaration – either through express language in the declaration or by reference to a trust document or in the insured's will. The separate insurance trust has been a widespread technique employed by estates practitioners for many years, allowing the best of all worlds: imposing a testamentary scheme on the insurance proceeds, on the one hand, while keeping the insurance proceeds out of the estate (and hence safe from estate administration tax and creditor claims), on

the other hand. Such a trust would be considered separate from other trusts and has potential for further significant income tax savings.

While It is common for these trusts to name the child (or other primary beneficiary of a lifetime trust) as the sole trustee and there would appear to be no grounds for Canada Revenue Agency to look through the trust and treat the child as the sole beneficial owner of the assets the better practice and more conservative approach would be to have more than one trustee, or to remove the unilateral right to distribute the entire trust fund to the child, or otherwise to reduce the child's control over the assets.

9. **DOUBLE WILLS.** Probate (formally known as a Certificate of Appointment of Estate Trustee(s)) is simply a method of certifying that a named person or people has or have the right to deal with, sell or otherwise transfer property owned by a person who has died. If there is no property to transfer, such as in a case where husband and wife hold everything as joint tenants or on joint account, there is no probate required. This is often the case on the death of the first of a married couple. On the second death where there are properties to dispose of probate is needed. As previously noted probate requires payment of Estate Administration Tax and there are also legal fees to be paid for applying for and obtaining the court certificate appointing the estate trustee.

The practice has now developed of executing a separate Will for the assets that will require probate and another for the assets that will not require probate. A Certificate of Appointment will be obtained only with respect to the Will dealing with the assets of the "primary estate" or "public estate" for which probate is required. This would include land, bank accounts and investment assets registered in the testator's name alone. Estate administration tax is paid on the value of these assets only. The other will deals with the "secondary estate" or "private estate". This includes personal effects and debts owing by or shares held in privately held corporations, which the testator owns all of, or which he or she owns with family or friends on the assumption that these people would not demand a Certificate of Appointment of Estate Trustees when paying debt or transferring shares. One must be very careful in drafting wills for primary and secondary estates to ensure that one will does not revoke the other and that the assets are properly described.

ESTATE ADMINISTRATION TAX ENFORCEMENT

New enforcement proceedings have been put into effect as of January 1, 2015, which are designed to increase the amount of tax recovered by the Government of Ontario. The Government's position now is that, the transfer of any property (land, bank accounts, investments or other assets) to joint tenants, if made for the purpose of having the individuals hold as trustees (meaning that the transfer is not made as a gift), is taxable, even though probate may not required for disposition of the property. Therefore, the Government requires that the value of the property be included in the Estate Administration Tax Return, which will be filed on behalf of the Estate.

There are, however, two exceptions to this requirement, as follows:

a. Where no Certificate of Appointment (probate) is required because there are no assets that require it. That means that **everything** (real property, bank accounts, investment accounts and otherwise) would be on joint tenancy (for bank and investment accounts "as joint tenants with right of survivorship"), or in the case of insurance policies, RRSPs, RRIFs and TFSAs, beneficiaries are named that so that the contents of the account or policy automatically passes to them. If no probate need be applied for, then no Estate Administration Tax need be paid.

b. Where there are assets which may require probate, it is possible to reduce the Estate Administration Tax payable by making double wills as noted above. A Primary Will, deals with assets that require probate, such as land or accounts that are owned by the deceased alone, without any Joint Tenants. Estate Administration Tax will be payable on the assets dealt with under that will. A Secondary Will, deals with assets that do not normally require probate. This would include shares of private corporations and property or accounts held on joint tenancy or joint account for which the surviving joint tenant has agreed will be distributed to various Estate beneficiaries. No Estate Administration Tax is payable on the assets dealt with under that will.

It is therefore important that you to very carefully review your assets and ascertain whether the first exception applies to you. ALL of your accounts should be held jointly, with right of survivorship so that, on death, all of the accounts pass to the survivor (this would include naming beneficiaries of RRSPs, RRIFs, TFSAs and life insurance policies). If this is not the case, then you should make new wills so that you have both a Primary Will and Secondary Will so that Estate Administration Tax is not charged on property transferred to joint tenants or held on joint account.