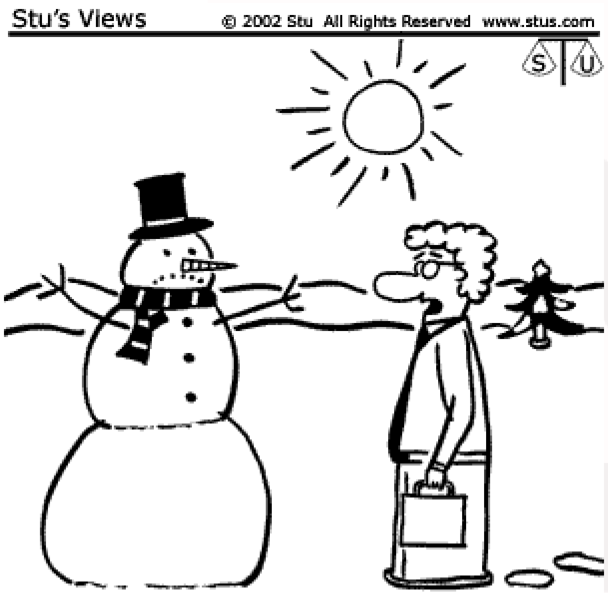
Estate and Probate Planning – Using Trusts Tax Efficiently

PEI CBA WET SECTION

JANUARY 24, 2017

PRESENTED BY:

RICHARD NIEDERMAYER



"Mr. Frosty, it's March.
Time to talk estate planning."

Agenda

- Why probate planning?
- Why is this relevant to WET practitioners?
- How do you plan for probate?
- Inter Vivos Trusts
- Alter Ego, Joint Partner and Self-Benefit Trusts
- Spousal Trusts
- Testamentary Trusts
- Bare Trusts
- Conclusion

Why Plan for Probate?

- The probate process has built-in delays which can slow down the transfer of assets to beneficiaries
- Probate causes additional professional fees to be incurred
- Probate taxes/fees are typically payable on the total fair market value of the estate assets

Why Plan for Probate? (Cont'd)

- Probate taxes/fees vary from province to province from highest to lowest (top rates below):
  1. Nova Scotia - 1.695%
  2. Ontario – 1.5%
  3. British Columbia – 1.4%
  4. Saskatchewan and Manitoba – 0.7%
  5. Newfoundland and Labrador – 0.5%
  6. New Brunswick – 0.5%
  7. Prince Edward Island – 0.4%
  8. Alberta - $400
  9. Yukon - $140
  10. Quebec - $85

Why Plan for Probate? (Cont'd)

- Enhanced creditor proofing may be gained (including against dependent relief claims that may attach to assets that pass through probate)
- Simplification of administration of domestic estate if assets are already in one succession structure
- Simplification of succession process for foreign assets if have multijurisdictional holdings
- Reduced risk of challenge to deceased's estate plan on basis of testamentary capacity and undue influence if the alternate succession structure has been put in place well in advance of death

Why Plan for Probate? (Cont'd)

- Continuity of management and administration of assets by successor owners/trustees – no frozen assets which therefore enhances liquidity
- Enhanced incapacity planning compared with a power of attorney – more comprehensive powers, more continuity of management, better protection for the incompetent/beneficiaries, greater recognition in foreign jurisdictions
- And finally, the probate process is public – avoiding it preserves confidentiality

Why Plan for Probate? (Cont'd)

- However, client still needs a valid will and enduring general power of attorney and personal directive to:

1. Address the disposition of assets not covered by alternate succession structures upon death
2. Provide for management and administration of any assets not covered by alternate succession structures in the event of incapacity
3. Provide for personal and healthcare decision making (not covered by any alternate succession plan)
4. Implement any powers of appointment held by the client

Probate - and Probate Avoidance!

Why is this particularly relevant to WET practitioners?

- Probate planning should follow after the tax plan for high net-worth clients for the reasons noted previously
- But, the probate plan can negatively affect the tax plan – caution !
- How do trusts and other structures create opportunities and challenges?

How to Plan for Probate

- Gifts to beneficiaries before death
- Joint ownership with right of survivorship
- Designations of beneficiaries (for RRSPs, RRIFs, TFSAs and insurance policies)
- Trusts established during lifetime – alter ego, joint partner and bare trusts
- Multiple/double wills (used in some provinces, but not possible in NS or used in PEI)
- Inter-provincial planning to reduce or avoid probate

How to Plan for Probate (Cont'd)

- Caution: unless the probate avoidance transactions occur between spouses so that a spousal rollover is available, the tax implications of each type of probate avoidance mechanism must be addressed

Inter Vivos Trusts

A. What Is it?

- Any trust created by a settlor during her lifetime

B. Tax Implications

- Property transferred to the trust will trigger a capital gain
- Trust is taxed on income retained in it, but can get a deduction for amounts allocated to beneficiaries
- 21 year rule applies

Inter Vivos Trusts (Cont'd)

C. Pros and Cons

- May permit the transfer of assets on death without having those assets pass through probate under the will
- Negative tax implications often make it an unattractive alternative

Inter Vivos Trusts (Cont'd)

- Could be useful for non-income producing assets such as a cottage property that has not appreciated much since acquisition
- Need to address ongoing maintenance, repairs and other expenses of ownership (i.e. property tax)
- Preserves continuity of ownership

Alter Ego and Joint Partner Trusts

A. What Is It?

- A specific exception in s. 73 of the ITA makes these types of inter vivos trusts much more attractive
- Alter ego trust – for the sole benefit of settlor during her lifetime
- Joint partner trust – for the joint benefit of settlor and her spouse or common-law partner for their joint lifetimes
- Both of these only apply to individuals over 65 years of age

Alter Ego and Joint Partner Trusts

B. Tax Implications

- **Note: Some of these rules were changed on January 1, 2016 and then changed back – more later!**
- Transfer of assets by the settlor occurs on a rollover basis
- Income/gains on those assets then taxed in the hands of the settlor during her lifetime at her graduated rates and in the trust upon and after death at the highest rate
- The 21 year deemed disposition rule does not apply until after the settlor's death
- The trust is required to file annual income tax returns and report the attribution of income to the settlor

Alter Ego and Joint Partner Trusts (Cont'd)

B. Tax Implications (cont'd.)

- Issues related to double tax – carrying back losses
  - Typical loss carry back rules do not apply (subsection 164(6))
  - Need to rely on the general loss carry back rules in section 111
  - Affiliation is a concern as the subsection 40(3.61) exception is no longer available
- Issues related to double tax - roll and bump strategies
  - Is a roll and bump/pipeline strategy available?
  - Was control acquired by virtue of someone's death?
- Careful planning is needed when private company shares are held in an alter ego or joint partner trust

Alter Ego and Joint Partner Trusts (Cont'd)

B. Tax Implications (cont'd.)

- Donations made by the trust may be less effective than donations made in the will
  - The donation credit is limited to 75% of the trust's income (versus 100% if through the will)
  - The ability to make donations must be contemplated in the trust and the charity cannot be considered an income or capital beneficiary
  - Timing of death is somewhat of a concern (ie. December 30th) – but have 90 days after year end to effect gift
  - But can convert capital gain to dividend on shares (by redemption) which then gets 100% deduction when add the gross-up for the dividend tax credit to the 75% limit

Alter Ego and Joint Partner Trusts (Cont'd)

- Spousal and other testamentary trusts have access to the $800,000 (indexed after 2014) capital gains exemption by virtue of subsection 110.6(2) or (2.1) but alter ego trusts and joint partner trusts do not
  - On the transfer of such assets to an alter ego or joint partner trust, it would be advisable to elect out of the rollover provisions in section 73 thereby triggering a capital gain so as to take advantage of the exemption

Alter Ego and Joint Partner Trusts (Cont'd)

C. Compliance

- Trust only covers assets transferred to it – need to ensure all settlor's assets are held in the trust if it is to be a true "will substitute"

D. Pros and Cons

- A tax-effective way to avoid probate
- Assets pass under the trust, not the will
- Can be considered a "will substitute"

Alter Ego and Joint Partner Trusts (Cont'd)

- Protects against incapacity
- Substitute trustees maintain continuity of administration of trust assets if settlor becomes incompetent
- If trust is irrevocable with no power to encroach on capital during settlor's lifetime, will protect the capital (but not income) from creditors (including for dependent relief claims)
- Main drawback historically was inability to transfer assets to a testamentary trust

Self-Benefit Trust

- Trust for the sole benefit of the settlor (cannot have beneficiary named other than the settlor)
- Settlor reports all income/gains during lifetime and has a rollover on transfer to trust
- On death, all income/gains attribute to settlor
- Can avoid probate if trust gives settlor a power or appointment by will over trust capital on death
- <u>But</u> if need to probate for any other reasons then must include trust assets
- No creditor proofing with a self-benefit trust

Spousal Trusts

A. What Is It?

- Similar to alter ego and joint partner trusts, but established by only one spouse to benefit the other spouse solely

B. Tax Implications

- Settlor transfers property on a rollover basis on death or on an inter vivos basis to a trust for the sole benefit of her spouse

Spousal Trusts (Cont'd)

- Spouse must be entitled to receive all of the income while alive and no one else can receive income or capital from the trust while the spouse is alive

C. Pros and Cons

- Alternate beneficiaries (i.e. children) can be named on spouse's death
- A way to preserve assets in the event of re-marriage by a spouse (if limit access to capital)

Spousal Trusts (Cont'd)

- Subject to spousal attribution rules if trust is inter vivos
- Can elect out of the spousal rollover provisions if, for example, the property transferred would otherwise qualify for the $800,000 enhanced capital gains exemption for qualified small business corporation shares

Section 104(13.4)

- Amendments to the *Income Tax Act* first released on August 29, 2014, were going to introduce a new rule in ss. 104(13.4) that would have been **VERY** problematic
- Applied to alter ego, joint partner and spousal trusts
- Effect of the rule was to:
  - deem the taxable capital gain arising from the deemed disposition of trust property on the death of the settlor/spouse to be the income of the settlor/spouse and not the trust

Section 104(13.4) (Cont'd)

  - deem a year end to occur at the end of the day when the settlor/spouse dies and start a new taxation year for the trust the following day
- This rule was effective on January 1, 2016 for deaths that occurred after that date
- **BUT** Department of Finance released draft legislation on January 15, 2016 that eliminated the proposed changes

Testamentary Trusts

A. What Is It?

- Established in the settlor's will at the time of her death
- Assets pass through the settlor's estate, but are then transferred to or held by the trustee of the testamentary trust
- Probate tax payable on those assets

Testamentary Trusts (Cont'd)

- Income tax savings used to far outweigh the probate tax over time

B. Tax Implications

- Testamentary trust could take advantage of the graduated tax rates in the Income Tax Act until December 31, 2015
- Different than an inter vivos trust which pays tax at the highest marginal rate

Testamentary Trusts (Cont'd)

- Depending on type of income earned in the trust and province of residence of the trust for tax purposes, tax savings could have been about $15,000 per year per trust (subject to s. 104(2))
- Could be combined with a spousal trust to create a testamentary spousal trust

Testamentary Trusts (Cont’d)

C. Pros and Cons

- Was useful in many situations:
- Spouses who have significant income in their own name
- Adult children who have significant income of their own (separate trusts for each child were best)
- Access to capital could be as tight or as loose as required
- Income splitting was also a real benefit (through seeding or residual trusts)
- Used to work equally well for insurance trusts and RRSP/RRIF trusts in terms of rate splitting between trust and beneficiary

Testamentary Trusts (Cont'd)

Continue to be useful:

- To protect assets from marriage breakdown
- To preserve continuity of ownership (i.e. cottage property, family business)
- To benefit charity after assets are no longer needed to support family
- Many other non-tax reasons for them (such as, spendthrift beneficiaries, blended families, incapacitated or vulnerable beneficiaries, U.S. estate tax by-pass, avoidance of double probate, creditor proofing for beneficiaries, etc.)

Testamentary Trusts (Cont'd)

- Effective January 1, 2016, several changes apply to testamentary trusts:
  1. Graduated rates for testamentary trusts gone – top marginal rate will now apply to testamentary trusts and grandfathered *inter vivos* trusts (pre-June 18, 1971)
  2. Estates which are "graduated rate estates" or "GREs" will still obtain graduated rates for 36 months – note: this is the estate itself, not the trust, though can designate a particular testamentary trust as the GRE (only one GRE per taxpayer)

Testamentary Trusts (Cont'd)

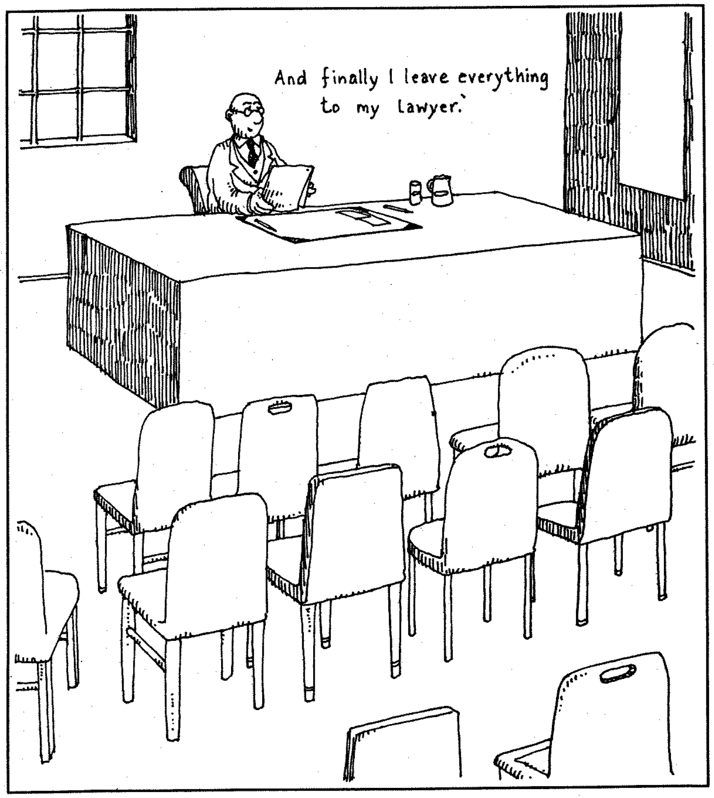
3. Limited exception for qualified disability trusts (specifics beyond the scope of this presentation)
4. Testamentary trusts must now have a calendar year end starting January 1, 2016
   - Existing trusts with non-calendar year ends had a deemed year end on December 31, 2015, as did existing estates that are not GREs (i.e. estates older than 36 months)
   - GREs can still choose an off-calendar year end but they lose the status 36 months post date of death

Testamentary Trusts (Cont'd)

5. Testamentary trusts must now remit quarterly installments – exception for GREs
6. Testamentary trusts will be subject to alternative minimum tax, will have liability for Part XII.2 tax, and will no longer be able to make investment tax credits available to beneficiaries

Testamentary Trusts Tax Benefits

1. "Estate fund" type trusts for income splitting/sprinkling among class of beneficiaries
2. "Top up" trusts to maximize use of beneficiary's graduated rates
3. Income "paid or payable" to a minor
4. Limited exception for trust for a disabled beneficiary


And finally I leave everything
to my lawyer.

Bare Trusts

A. The Strategy

- A true bare trust involves transfer of legal title of an asset by one person (the owner) to another person or persons (the "trustee") while retaining beneficial interest in the asset
- More of an agency relationship between owner and trustee
- Can arise in the context of making an asset held in joint tenancy (JTWROS) between owner and trustee as well
- For probate purposes, legal title in that asset is transferred to the trustee and it is therefore not probateable in the owner's estate upon the owner's death

Bare Trusts (Cont'd)

- Trustee signs a declaration of bare trust confirming intention not to obtain any beneficial interest in the asset
- Trustee is holding the asset in trust for the owner during her lifetime and then for her personal representatives (executors) after death
- Trustee(s) is usually the personal representative(s) as well
- A nominee holding company can be used as the bare trustee in more advanced planning (including a JTWROS arrangement for legal title to the shares of the nominee holdco among various individuals who are the ultimate executors)

Bare Trusts (Cont'd)

- Bare trusts can be used for investment accounts, bank accounts, private company shares and real estate

B. Tax Implications

- Because no transfer any beneficial interest to the trustee during the owner's lifetime occurs, no in the owner's hands is triggered until the owner's death
- Taxes are reported at that time based on the deemed disposition at fair market value in the owner's estate on the terminal tax return
- Owner reports income and gains from the asset during her lifetime

Bare Trusts (Cont'd)

C. Compliance Issues

- **One major drawback – if any asset needs to be probated, then generally all assets beneficially owned by the deceased need to be probated notwithstanding they may be held in the bare trust**
- **Extreme caution must be used to ensure all assets are outside of probate one way or another!**
- Bare trust arrangements should always be documented clearly in writing by a declaration of bare trust signed by the trustee

Bare Trusts (Cont'd)

D. Pros and Cons

- Why use a bare trust versus a regular JTWROS strategy?
- Ease of continuity of successor ownership and transfer of beneficial ownership with gift overs in a will
- Assets in the bare trust move into the estate, allowing loss planning and charitable gifting to occur, plus can then fund testamentary trusts created in a will notwithstanding that will is not probated
- A very powerful tool if used properly

Bare Trusts Versus Alter Ego/Joint Partner Trusts

1. Certainty re probate avoidance
   - AET/JPTs clearly cover what is in them – bare trusts can be broken if an asset that requires probate is left out
2. Ongoing trusts in AET/JPT versus will
   - As of January 1, 2016, there is no difference in taxation – both taxed at high tax rate on income retained in the trust with ability to allocate/pay income or make it payable to beneficiaries to “top up” their income and reduce/eliminate taxable income in the trust

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

- "Estate Fund" type trust can work under both structures for income splitting/sprinkling with multiple beneficiaries (i.e. children and grandchildren)
- Continue to be estate planning applications for spendthrifts, Henson trusts, U.S. estate tax bypass, creditor protection, etc. - appropriate in either structure

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

3. Post-mortem tax planning for private company shares not as easy with AET/JPT
   - Subsection 164(6) does not apply to an AET/JPT – must rely on general loss carry-back rules in s. 111
   - Consider affiliation issues as ss. 40(3.61) exception is no longer available
   - Plus deemed year end on death of settlor/spouse creates timing challenges
   - Is a roll and bump-pipeline strategy even available? Was control acquired by virtue of someone's death?

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

4. Capital gains exemption not available in AET/JPT at death of settlor/spouse
   - Must elect out of the rollover in ss. 73(1) on the transfer of shares into the trust to access the exemption
5. Timing of death an issue (though can't do much to plan for it)
   - Deemed disposition that arises on death of the settlor/spouse of an AET/JPT taxed in trust at high rates

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

6. Charitable giving was much more circumscribed with an AET/JPT until January 1, 2016 – now better re timing problem (but still have a credit problem!)
   - Donation credit was limited to 75% of the trust income versus 100% if through the estate/will (but if own private company shares that can be redeemed, then, with the dividend tax credit gross-up, the 75% limit could be increased to 100% on those assets)

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

- Must draft with discretion (typically coupled with a letter of wishes) in order to obtain any donation receipt for the trust – CRA will otherwise consider a directed gift to be a distribution to an income or capital beneficiary (the "credit problem")
- Timing of death is less of a concern now as can make the gift out of the trust within 90 days after the end of the calendar year (the "timing problem")
- New estate donation rules (5 year window) <u>not</u> applicable to a trust, only a GRE

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

7. Consider whether an AET/JPT should be a charitable remainder trust
   - Would require drafting to limit capital encroachment to an ascertainable amount (or zero) such that you get a tax credit for the present value of the future donation at the time of settlement
   - Trust must be irrevocable
8. Avoiding dependent relief claims better addressed in an AET/JPT
   - Because dependent relief statutes generally only apply to assets that pass by will (including those that are in a bare trust structure), only an AET/JPT will avoid such claims – **BUT** consider the PEI claw back

Client Checklist

- Want confidentiality generally – various strategies can work
- Over age 65 and want outright gifts after death - alter ego or joint partner trust
- Have significant non-registered assets and want testamentary trusts for spouse/children or have large charitable gifts – bare trust

Conclusion

- Estate planning generally and probate avoidance planning specifically are customized processes – each plan is unique
- Various tools are available to maximize the benefits and minimize the risks
- Can combine strategies as part of hybrid planning (i.e. combine an alter ego trust for certain assets with a JTWROS bare trust for private company shares and to provide for charitable gifts)
- The goal is to create a customized plan that is best for each client's personal circumstances

“Well, we’ve licked taxes—that just leaves death.”

Questions

???

Contact Information

Richard Niedermayer, TEP
Partner
Stewart McKelvey
Purdy's Wharf, Tower I
1959 Upper Water Street, Suite 900
Halifax, Nova Scotia B3J 3N2
RNiedermayer@stewartmckelvey.com
Tel: 902-420-3339
www.stewartmckelvey.com