Tax-Efficient Probate Planning

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Agenda

- Why probate planning?
- Why is this relevant to tax practitioners?
- How do you plan for probate?
- Selected tax and compliance issues
- Conclusion
- Background slides
- Gifts
- Joint ownership
- Beneficiary designations
- Insurance & RRSP trusts
- Alter ego & joint partner trusts
- Bare trusts
- Client Checklist

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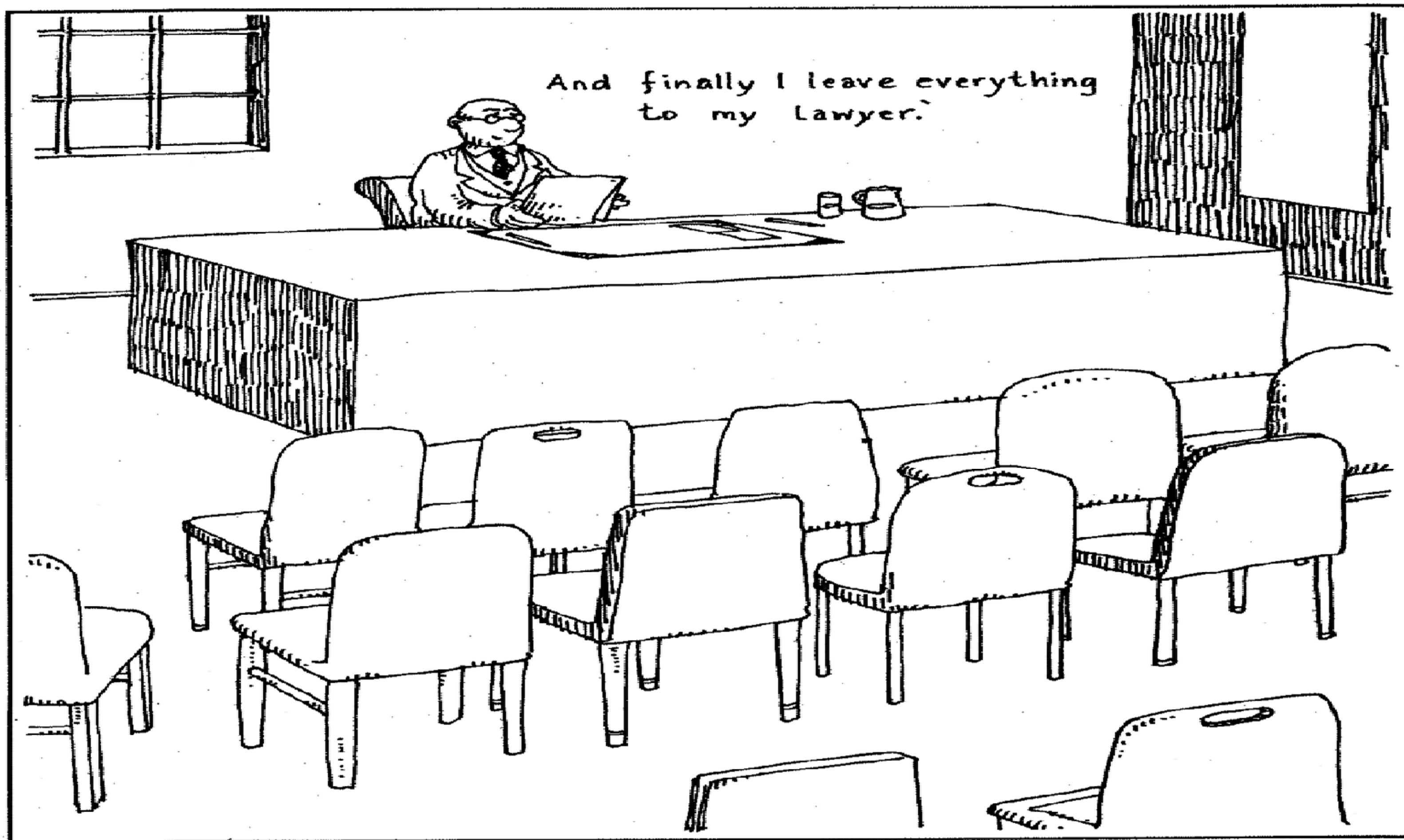

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Why Plan For Probate?

- 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

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Why Plan For Probate? (cont'd)

- Probate taxes/fees vary from province to province from highest to lowest (top rates below):
  1. Nova Scotia - 1.553%
  2. Ontario – 1.5%
  3. British Columbia – 1.4%
  4. Saskatchewan and Manitoba – 0.7%
  5. Alberta - $400
  6. Yukon - $140
  7. Quebec - $85
- Enhanced creditor proofing may be gained (including against dependent relief claims that may attach to assets that pass through probate)

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Why Plan For Probate? (cont'd)

- 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
- Continuity of management and administration of assets by successor owners/trustees – no frozen assets which therefore enhances liquidity

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Why Plan For Probate? (cont'd)

- 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 (i.e. Frank magazine) – avoiding it preserves confidentiality

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Why Plan For Probate? (cont'd)

- However, client still needs a valid will and enduring finance and health powers of attorney 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

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- Probate can and should follow at the end of 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 “off balance sheet structures” create opportunities and challenges?

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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 (in some provinces)
- Inter-provincial planning to reduce or avoid probate

- 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

Selected Tax and Compliance Issues

- **Insurance and RRSP/RRIF trusts :**
- **1** - should the document creating the trust be a “testamentary instrument” under applicable provincial laws?
- **2** - if so, is placing the designation directly in the will preferable?

- **Alter ego/joint partner trusts :**
- **1** - can you create a testamentary trust from the property of an AET or JPT through a power of appointment exercisable by will?

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Selected Tax and Compliance Issues (con't)

- **2** - 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 now a concern as the subsection 40(3.61) exception is no longer available
- **3** - 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

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Selected Tax and Compliance Issues (con't)

- **4** - donations made by the trust are 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 a concern (ie. December 30th)

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Selected Tax and Compliance Issues (con't)

- **5** - spousal and other testamentary trusts have access to the $750,000 capital gains exemption by virtue of subsection 110.6(2) or (2.1); AETs and JPTs do not
- on the transfer of such assets to an AET or JPT, it is advisable to elect out of the rollover provisions in subsection 73(1) thereby triggering a capital gain so as to take advantage of the exemption

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Selected Tax and Compliance Issues (con't)

- **Bare trusts** - 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

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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 non-income producing assets with a JTWROS bare trust for income producing investments, coupled with an insurance trust for a large life policy)
- The goal is to create a customized plan that is best for each client's personal circumstances

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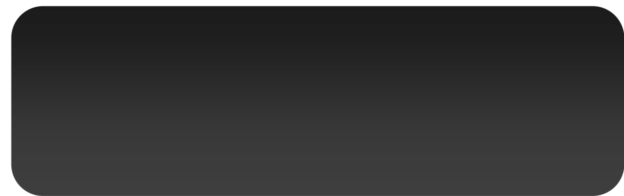

Questions

???

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BACKGROUND SLIDES

Gifts

A. The Strategy

- Gifts made during lifetime avoid probate in the estate of the donor
- Cannot be probated on what you do not own!

B. Tax Implications

- No gift tax in Canada, but donor is deemed to dispose of the asset at fair market value, triggering any gain (or a loss)
  - Effect is a prepayment of income tax
- Consider superficial loss rules and attribution rules for gifts to a spouse or minor children
- May be an opportunity for a gift of assets with inherent capital loss to an adult child as there is no attribution

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Gifts (cont'd.)

C. Compliance Issues

- Need to document the intention to gift the beneficial interest in the asset and then effect an actual transfer of legal title to the donee
- A deed of gift or equivalent instrument is recommended

D. Pros and Cons

- Simple
- But, if you have given it away you cannot get it back!
- May be appropriate when death is near – no tax prepayment penalty

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Joint Ownership

A. The Strategy

- Joint tenancy with right of survivorship (JTWROS) is one of the most common ways to avoid probate
- Can be used for most types of capital property
- Can hold assets JTWROS as between anyone (not just spouses)
- Separation of legal and beneficial title creates opportunities for probate avoidance planning

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Joint Ownership (cont'd)

- *Pecore* and *Madsen cases* have clarified certain presumptions that apply when two persons hold property JTWROS
- If spouses, presumption of advancement applies – upon death of one joint owner the other obtains legal title by operation of law pursuant to the joint tenancy and is presumed to acquire the beneficial interest as well
- If parent and adult child, presumption of resulting trust applies - upon death of parent child is presumed to hold the beneficial interest in the asset on resulting trust for the parent's estate notwithstanding the child obtains sole legal title by operation of law
- Both presumptions can be rebutted

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Joint Ownership (cont'd)

B. Tax Implications

- **Option 1:** if parent's intention on making the asset JTWROS is to immediately gift a beneficial interest to child, creates an immediate disposition for tax purposes in the hands of the parent, triggering any inherent capital gain (calculated by reference to parent's life expectancy and a future discount rate) plus both parent and child must report a proportionate amount of income and gains from the asset in the future while parent is alive

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Joint Ownership (cont'd)

- **Option 2:** No immediate transfer of beneficial interest to child, but intention to pass beneficial interest to child upon parent's death
  - child gets beneficial asset on death of parent outright

- **Option 3:** No immediate transfer of beneficial interest to child and no intention to pass beneficial interest to child upon parent's death (child holds interest in trust for parent's estate)
  - asset can be dealt with by child without probate (likely) and could fund testamentary trusts

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Joint Ownership (cont'd)

- Neither Option 2 or 3 triggers a disposition of beneficial interest during the parent's lifetime and parent continues to report all income and gains during lifetime and upon death

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Joint Ownership (cont'd)

C. Compliance Issues

- If Option 2, parent must document the intention to rebut the presumption of resulting trust
- If Option 3, should have child confirm that she holds her interest in the asset in a bare trust for the parent during the parent's lifetime and for the estate thereafter (more later) rather than rely on the presumption of resulting trust
- Best practice is to clearly document transferor's intention at the time asset made JTWROS or in transferor's will

Joint Ownership (cont'd)

D. Pros and Cons

- There are potential pitfalls of making an asset legally <u>and beneficially</u> owned by parent JTWROS with adult child:

1. Loss of control by parent
2. Potential exposure to child's creditors
3. Disputes among siblings over intentions
4. Death of child before parent
5. Tax implications

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Beneficiary Designations

A. The Strategy

- Applies to limited types of assets:
  - Insurance policies, segregated funds and related insurance assets under the provincial *Insurance Acts*
  - RRSPs, RRIFs, TFSAs (as of January 1, 2009), pensions and related retirement savings vehicles under various provincial statutes (i.e. *Beneficiaries Designation Act* in Nova Scotia)
- Assets will pass outside of probate directly to the designated beneficiary upon the death of the insured/annuitant
- If more than one designation, the later in time designation will apply
- Can have multiple beneficiaries and primary and contingent beneficiaries

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Beneficiary Designations (cont'd.)

B. Tax Implications

- Insurance proceeds pass tax free
- Registered investments will rollover to a spouse, but will otherwise trigger tax on a full income inclusion basis in the estate of the deceased annuitant
  - the tax falls on the estate but the asset passes outside of the estate to the beneficiary without any withholding tax – a potential mismatch of the incidence of tax which needs to be addressed as part of the overall estate plan
- Beneficiaries receive the insurance or registered plan proceeds in their own name and are then taxed personally on all the future income and gains on those assets

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Beneficiary Designations (cont'd.)

C. Compliance Issues

- Important to keep designations current with changing circumstances (i.e. separation/divorce, death of beneficiary)

D. Pros and Cons

- Simple, but may eliminate income splitting opportunities
- Problems can occur if beneficiaries predecease the insured/annuitant (ie. one of three children predeceases) or proposed beneficiaries are minors or spendthrifts
- Insurance and RRSP trusts may be attractive alternatives

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Insurance Trusts

A. The Strategy

- A form of testamentary trust funded with the proceeds of an insurance policy payable on death of the testator
- For personal (not corporate) owned insurance
- Executor and trustee of the will is designated as beneficiary “in trust” in the will or in a separate designation
- Terms of the trust can mirror the terms of testamentary trusts for spouse, children or other beneficiaries in the will or have separate terms (this may maximize income splitting opportunities for the beneficiaries)

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Insurance Trusts (cont'd.)

- If the trust is funded only from the proceeds of a life insurance policy, the terms of the trust have been established by an individual during his or her lifetime and the trust is separate from that individual's estate, CRA will treat that trust as a separate testamentary trust
- **Should the document creating the trust be a "testamentary instrument" under applicable provincial laws? If so, is placing the designation directly in the will preferable?**
- If the beneficiary is the executor and trustee (not "estate"), then the policy proceeds will also pass outside of probate

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Insurance Trusts (cont'd.)

B. Tax Implications

- If the trust is settled by the insurance proceeds on death and no one else has, or will, contribute property, the insurance trust should benefit from testamentary trust status
- Insurance proceeds will be received on a tax free basis by the trust

C. Compliance Issues

- Policy also retains its creditor exempt status under the applicable *Insurance Act* provided the beneficiaries of the trust are from the prescribed class of family members (spouse or common-law partner, child, grandchild or parent)

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Insurance Trusts (cont'd.)

D. Pros and Cons

- Useful in many situations:
  - Spouses who would otherwise name each other as direct beneficiaries of existing policies – an insurance trust creates income splitting opportunities for the surviving spouse that would not otherwise exist
  - Testators with adult children who may also benefit from income splitting
  - Testators with minor children who need testamentary trusts for estate planning purposes more than tax purposes

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RRSP Trusts

A. The Strategy

- Similar principles apply to testamentary trusts created with registered plan proceeds (RRSPs or RRIFs)
- Executor and trustee can be designated as beneficiary of the RRSP "in trust" on the same terms as the insurance trust noted previously
- RRSP proceeds still pass outside the estate from a probate perspective because they have a designated beneficiary
- Once paid out to the trustee, the plan proceeds will be a testamentary trust provided the same conditions as with an insurance trust noted previously are met

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RRSP Trusts (cont'd.)

B. Tax Implications

- **Caution** – the fair market value of the plan as of the date of death will still be taxed as income in the testator's estate on the terminal tax return, even if a spouse or common-law partner is the beneficiary of the trust – there is no rollover to the trust
- The estate will pay the tax notwithstanding that the separate trust receives the proceeds – this needs to be addressed as part of the overall estate plan

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RRSP Trusts (cont'd.)

- There have been proposals suggested by various professional bodies recommending changes to the ITA to permit a rollover of an RRSP to a spousal trust to preserve the non-tax benefits of using a spousal trust, particularly in a second marriage situation, without deregistering the plan and paying tax prematurely
- Until a legislative change occurs, caution should be used

C. Compliance Issues

- RRSPs retain existing creditor protection while the beneficiary designation is in force

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RRSP Trusts (cont'd.)

D. Pros and Cons

- This strategy may be useful for annuitants who have no spouse and would otherwise designate children or other beneficiaries directly and thereby miss the income-splitting benefits of a testamentary trust

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Alter Ego and Joint Partner Trusts

A. The Strategy

- 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
- Only applies to individuals over 65 years of age
- Assets pass under the terms of the trust upon death of the settlor/second spouse/partner, not through the settlor's estate
- Can be considered a "will substitute" with respect to the assets held in the trust

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Alter Ego and Joint Partner Trusts (cont'd.)

B. Tax Implications

- 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
- **Can you create a testamentary trust from the property of an alter ego or joint partner trust through a power of appointment exercisable by will?**

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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 now 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 moved to an alter ego or joint partner trust**

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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 a concern (ie. December 30th)

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Alter Ego and Joint Partner Trusts (cont'd.)

- **Spousal and other testamentary trusts have access to the $750,000 capital gains exemption by virtue of subsection 110.6(2) or (2.1); 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 of subsection 73(1) thereby triggering a capital gain so as to take advantage of the exemption**

C. Compliance Issues

- 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"

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Alter Ego and Joint Partner Trusts (cont'd.)

D. Pros and Cons

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

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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
- Really an agency relationship between owner and "trustee"
- Can arise in the context of making an asset JTWROS between owner and trustee as well as noted earlier
- 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
- Trustee signs a declaration of bare trust confirming intention not to obtain any beneficial interest in the asset

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Bare Trusts (cont'd.)

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

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Bare Trusts (cont'd.)

B. Tax Implications

- A bare trust, because it does not transfer any beneficial interest to the trustee during the owner's lifetime, does not trigger a disposition in the owner's hands 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

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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

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Bare Trusts (cont'd.)

D. Pros and Cons

- Why use a bare trust versus a regular JTWROS strategy (Option 1 or 2)?
- Ease of continuity of successor ownership and transfer of beneficial ownership with gift overs in a will
- Assets in the bare trust can fund testamentary trusts created in a will notwithstanding that will is not probated – a significant income splitting advantage
- A very powerful tool if used properly

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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 personal life insurance – insurance trust for spouse/children
- Have registered assets, no spouse and children – RRSP trust (but be mindful of the tax at death)
- Have significant non-registered assets and want testamentary trusts for spouse/children – bare trust

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