Tax Efficient Probate Avoidance

STEP Canada (Atlantic Branch)

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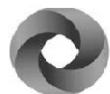
Agenda

- What is probate?
- Why avoid probate?
- What is a trust?
- Taxation of trusts
- Testamentary trusts
- Taxation on death
- How do you avoid probate?
- Gifts
- Joint ownership
- Beneficiary designations
- Insurance & RRSP trusts
- Alter ego & joint partner trusts
- Bare trusts
- Client Checklist
- Conclusion

And finally I leave everything to my lawyer.



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What is Probate?

- Probate is the process of obtaining court approval of a will
- Provides confirmation that testator is deceased, that she left a will and that the executor named in the will has authority to act
- If no will, "administration" can be granted by the court
- Probate is typically required by financial institutions in order to deal with estate assets
- Customarily required when land is held solely in the name of a deceased person (always the case in Nova Scotia)

Why Avoid 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 payable on the total fair market value of the estate assets (net of debt secured against land in Nova Scotia)

Why Avoid Probate? (cont'd)

- Probate taxes/fees vary from province to province from highest to lowest:

  1. Nova Scotia - $902.03 on first $100,000 and $15.23 on every $1,000 thereafter = $14,609.03 total on a $1,000,000 estate
  2. Newfoundland and Labrador - $60 on first $1,000 plus $30 for the order plus $5 on every $1,000 thereafter = $5,085 total
  3. New Brunswick - $100 on first $20,000 and $5 on every $1,000 thereafter = $5,000 total
  4. Prince Edward Island - $400 on first $100,000 and $4 on every $1,000 thereafter = $4,000 total

- Enhanced creditor proofing (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 of multijurisdictional holdings

Why Avoid Probate? (cont'd)

- 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

- 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

Why Avoid Probate? (cont'd)

- However, still strongly recommended that client has 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)

What is a Trust?

- A legal relationship whereby one person (the settlor) transfers property to another person (the trustee) to hold for the benefit of others (the beneficiaries)
- The settlor, trustee and beneficiary can all be the same person, but usually two or more persons fill those roles
- Creates separation of legal and beneficial title to the trust assets
- A formal trust agreement or trust deed is typically required
- Trusts established during someone’s lifetime are inter vivos
- Testamentary trusts are established in a will

What is a Trust? (cont'd)

- Not a separate legal person
- Deemed a person for income tax purposes
- Trustee is a fiduciary and must always act impartially and in the best interests of the beneficiaries
- Trusts can be revocable or irrevocable, fixed interest or discretionary
- Investments by the trustees can be limited or expanded in the trust agreement or left to the "prudent investor" standard in the various provincial *Trustee Acts*

What is a Trust? (cont'd)

- Trusts are private (unlike a probated will) and so preserve confidentiality
- Trust assets are generally free from claims by creditors, including those challenging an estate plan
- A very flexible tool for estate planning
- Main drawback is the settlor's loss of control over the assets transferred to the trust

Taxation of Trusts

- Detailed and specific rules in the *Income Tax Act* (ITA)
- Exceptions to almost every rule
- The settlor generally pays tax on accrued capital gains on assets settled to the trust – a disposition for tax purposes
- Income retained in a trust is taxed at the top marginal rate for individuals for inter vivos trusts

Taxation of Trusts (cont'd)

- Income paid or payable to beneficiaries is taxed in the hands of those beneficiaries
- The trust receives a deduction for all amounts paid or made payable to the beneficiaries
- If the trust is revocable, or if the settlor retains significant control over the trust assets, all income (including capital gains) is taxed in the hands of the settlor
- If the trust is irrevocable and the beneficiaries are under 18 years of age, income (interest and dividends) is taxed to the hands of the settlor, but capital gains can be taxed in the hands of the minor beneficiaries

Taxation of Trusts (cont'd)

- Detailed rules apply to the "attribution" of income to the settlor, spouses and minor children and grandchildren

- All property held by a trust is deemed disposed of every 21 years after the year the trust was created and any resulting capital gain (or loss) calculated and taxed

Testamentary Trusts

- 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 (at rates noted earlier) is generally payable on those assets
- Income tax savings far outweigh the probate tax over time
- Testamentary trust can take advantage of the graduated tax rates
- Different than an inter vivos trust which pays tax at the highest marginal rate

Testamentary Trusts (cont'd)

- Tax savings can be over $10,000 per year depending on asset size and type of income earned

- Can be combined with a spousal trust to create a testamentary spousal trust and obtain a rollover to the spouse (the spouse must be entitled to all of the income of the trust and no one else can be a beneficiary during the spouse's lifetime)

Testamentary Trusts (cont'd)

- Useful in many situations:
  - Spouses who have significant income or income producing assets of their own
  - Adult children who have significant income or income producing assets of their own (separate trusts for each child are best)
  - 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
- Access to capital can be as tight or as loose as required
- As little as $300,000 placed in a testamentary trust can be tax effective if there are no trustee fees taken and the only extra cost is filing a tax return

Taxation on Death

- Capital property deemed disposed of at fair market value on death

- Tax-free rollover to a spouse is available (tax deferral)

- Transfer to spouse can be outright or in a trust (spousal trust)

- RRSPs/RRIFs fully taxable as income unless a spouse is the designated beneficiary

Taxation on Death (cont'd)

- Only addresses first spouse to die – taxes are payable when the second spouse dies

- There are ways to address this:
  - Life insurance to fund the tax liability
  - Charitable gifts in the will to offset income tax otherwise payable
    - Note: if the estate assets include marketable securities, consider gifting those securities directly to the charity which reduces the capital gain on those securities

How to avoid probate

- There are four main ways to avoid 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
- Caution: unless the probate avoidance transactions occur between spouses so that a spousal rollover is available, the income tax implications of each type of probate avoidance mechanism must be addressed

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 of fair market value, triggering any gain (or a loss)
- Consider superficial loss rule (30 day wait before reacquisition of asset by donor or affiliated party) and attribution rules for spouse or minor children
- May be an opportunity for gift of assets with inherent capital loss to an adult child as is no attribution

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!

Joint Ownership

A. The Strategy

- Joint tenancy with right of survivorship (JTWROS) is one of the most common ways to avoid probate
- Not to be confused with tenants in common – that does not avoid probate
- JTWROS is the most common way for spouses to own their matrimonial home and often other assets (bank accounts, investment accounts, vehicles, household furnishings etc.)
- Can be used for other assets such as shares of a private holding company
- Can hold assets JTWROS as between anyone (not just spouses)
- Separation of legal and beneficial title creates opportunities for probate avoidance planning

Joint Ownership (cont'd)

- Recent Supreme Court of Canada cases *Pecore* and *Madsen* 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

Joint Ownership (cont'd)

B. Tax Implications

- 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 (Option 1)
- Not usually the parent's intention
- Two other options

Joint Ownership (cont'd)

- No immediate transfer of beneficial interest to child, but intention to pass beneficial interest to child upon parent's death (Option 2)

- 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) (Option 3)

- Option 2 means child gets beneficial asset on death of parent outright

Joint Ownership (cont'd)

- Option 3 means asset can be dealt with by child without probate (likely) and could fund testamentary trusts
- 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

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 and beneficially 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

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 which have a designated beneficiary will pass outside of probate directly to that 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

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
- Note: 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

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

Insurance Trusts

A. The Strategy

- A form of testamentary trust funded with the proceeds of an insurance policy payable on death of the testator

- Executor and trustee of the will is designated as beneficiary "in trust" in the will

- 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)

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 testamentary trust

- The document creating the trust should be a "testamentary instrument" under applicable provincial laws such that placing the designation directly in the will is preferable

- If the beneficiary is the executor and trustee (not "estate"), then the policy proceeds will also pass outside of probate

Insurance Trusts (cont'd.)

B. Tax Implications

[Heath to add recap of testamentary trust and income splitting plus confirm proceeds still tax free initially]

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)

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

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

RRSP Trusts

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 a 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

RRSP Trusts

- Amendments to the ITA permitting rollover of an RRSP to a spousal trust have been proposed 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 that legislative change occurs, this strategy is not very attractive as between spouses or common-law partners

C. Compliance Issues

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

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

Alter Ego and Joint Partner Trusts

A. The Strategy

- A specific exception in the ITA makes these types of inter vivos trusts attractive

- Only applies to individuals over 65 years of age

- 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

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

- Assets pass under the terms of the trust upon death of the settlor/second spouse/partner, not the settlor's will
- Can be considered a "will substitute" with respect to the assets held in the trust

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

B. Tax Implications

- Transfer of assets by settlor occurs on a "rollover" or tax neutral 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

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

- Beneficiaries after death of settlor (and settlor's spouse) can be settlor's family or other beneficiaries

- A tax-effective way to avoid probate

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"

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

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

- Main drawback is inability to transfer assets to a testamentary trust

- Usually need at least $400,000 in assets to justify the expense to set-up and maintain the trust

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

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

Bare Trusts (cont'd.)

B. Tax Implications

- From an income tax perspective, a bare trust, because it does not transfer any beneficial interest to the trustee during the owner's lifetime, does not trigger any 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

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

D. Pros and Cons

- Why use a bare trust versus a regular JTWROS strategy (Option 1 or 2)?

Bare Trusts (cont'd.)

- 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

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 life insurance of $300,000 or more – 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

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
- Professional legal and tax advice is strongly recommended

Questions

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