Aging Boomers up the Estate Planning Ante – Part II

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This continues our discussion of estate planning for baby boomers from the March issue of *Tax Notes* (The federal budget, particularly its far-reaching proposals relating to the financing of foreign affiliates, interrupted our discussion.) As I said in March, the confluence of the greatest wealth transfer in history and increasingly complex tax laws has altered the landscape for estate planners. A good example - discussed in Part I of this article - is the impact of the FIE and non-resident trust proposals on beneficiaries of foreign trusts and estates, which have forced many estate planners to become familiar with these super-complex rules. Also, increased mobility will raise international tax issues, especially for those who relocate to the US with interests in investment-type corporations.

Wealthy Owner-Managers – A Holistic Approach?

Apart from this, it has long been my contention that, in the owner-manager context at least, good estate planning advice requires a holistic approach which includes both personal and corporate tax knowledge - specifically to "drill down" to the underlying corporate structure in order to determine the effect that corporate-level assets and transactions might have on an estate plan, notably, *post-mortem* procedures. In this respect I believe that relatively recent tax changes have upped the ante considerably.

There is no better example than the eligible dividend regime. The ability to pay eligible dividends may be important to *post-mortem* planning. For example, a subsection 164(6) "carryback" against terminal period gains may be more efficient if the taxable dividend generated in the estate is an eligible dividend. Where there is non-grandfathered corporate-owned life insurance, death taxes can be minimized by the so-called "50% solution", which involves the repurchase of the decedent's corporation's shares held by the estate for a 50% capital dividend/50% taxable dividend**[i]**. Prior to the eligible dividend rules, the "50%" solution was, in reality, more like a "33% solution", because of the relatively high tax rate attaching to non-eligible dividends. However, the tax rate on taxable dividends will be reduced to the extent that eligible dividends can be paid.

The maximization of eligible dividends may involve, for example, the determination of whether a subsection 89(11) election is advisable (whereby the corporation will fall under the "eligible-dividends-by-default" regime). Also, the decision of whether or not to bonus to the small business limit will become more relevant in the estate planning context.

More generally, the significance of eligible dividends is that we now have a comprehensive system of integration of major types of Canadian-source income earned by private corporations, including high rate business income. This heightens the importance of corporate-level transactions in the estate planning context, since these can be accomplished on a more tax-efficient basis.

Some "Housekeeping Tips" for the Wealthy

Where particularly wealthy individuals are involved, there is a tendency to overlook a number of "housekeeping" matters when it comes to estate planning. Consider the following:

- **Personally-held Assets.** Sometimes there will be little attention paid to personally-held assets, as opposed to those at the corporate level. Once upon a time, there was a provision in the *Income Tax Act* which limited death tax exposure to 50% of recapture. However, that provision was removed years ago, so that the full amount of recapture is potentially taxable. It may be advantageous to transfer buildings and other assets exposed to recapture into a corporation**[ii]**, so that the exposure on the deemed disposition would be treated as a capital gain, rather than fully taxable**[iii]**.

- **"Pre-Mortem" Redemptions.** If a corporation is generating refundable tax and/or capital dividend account, it may be beneficial to systematically redeem freeze shares – i.e., because the personal tax resulting from deemed dividends on redemption would largely be tax-paid. This will reduce the exposure from the deemed disposition on death and could also reduce the need for

cumbersome and expensive *post mortem* reorganizations. In a freeze situation, it may make sense to inject investment assets into the corporate system in order to maximize this effect.

- **Don't forget about the freeze itself!** Time after time, I have seen clients who provide elaborate instructions in their wills, with no thought given to the value accumulated in their family trusts. I recently dealt with a file involving a wealthy client who did a will with an elaborate scheme of distribution to his kids. Trouble is, he lost sight of the fact that he had done an estate freeze some years ago – and the fact that his personally-owned assets now accounted for only a minority of the value of his family's business and investments. There was no guidance as to whether the scheme of distribution should be replicated by the trustees (or for that matter how the common shares held by his family trust should be distributed), without which the trustees could rapidly face fiduciary issues. The moral of the story: don't forget to take the estate freeze into account when it comes to estate planning.

Family Law Considerations

The family law impact of estate planning is hardly a new topic. However, much of the discussion has focused on considerations relating to the freezor, as opposed to the beneficiaries.

One of the reasons for this is that, when estate freezes are carried out, the beneficiaries may be fairly young and family law complications seem remote. However, the typical 21-year life span of a family trust is not a long period of time. During that period children and grandchildren can get married or remarried, often with adverse family law consequences. I will use Ontario as an example. If a freeze was effected prior to marriage, it is not at all clear that a distribution from a trust after marriage will be totally family-law protected; an argument can be made that the value of an interest in a discretionary family trust at time of marriage is low, leaving the post-marriage appreciation up for grabs**[iv]**. If, on the other hand, the assets are simply left in a will, there should be no family law issues if the actual bequest takes place after marriage.

Conclusion

As can be seen, estate planning for wealthy boomers now brings into play some very complex rules in the tax area and otherwise. Advisors who are unaware of them act at their peril.

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[i] The stop-loss rules in subsection 112(3.2) may "force" taxable dividends of magnitude equal to capital dividends; otherwise part or all of the loss will be denied.

[ii] Or partnership.

[iii] Even at the expense of land transfer tax.

[iv] See *Black* v. *Black* (1988) 18 R.F.L. (3d) 303 (Ont. H.C.). However, in *Sagl* v. *Sagl,* (1997), 31 R.F.L. (4th) 405, additional reasons (1997), 35 R.F.L. (4th) 107) (Ont. C.J. (Gen. Div.)), the value of the discretionary interest in a family trust was determined (both at the date of marriage and the valuation date) by dividing the value of the corpus of the trust by the number of discretionary beneficiaries at the two dates.

It seems to me that the same sort of issue can arise with the use of an *alter-ego* (or joint partner) trust, rather than a will. If assets are transferred prior to marriage/remarriage, at least in some circumstances, I can see an argument being made that the distribution from these trusts would not be completely family-law protected. If the trust is revocable or capital distributions can be made from the *alter ego* or joint partner trust, it could be argued that the value of the interest in the trust may be low, in comparison with the amount of the actual distribution received after marriage.