ESPG
We bring reason to numbers & numbers to reason

Estate Planning for Individuals

Objectives

In general the objectives of effective estate planning are to:

1. Ensure that you and your family are provided for adequately now and in the future, and that your heirs are adequately provided for after you death;
2. Distribute assets according to your wishes, both during your life time and on your death, with a view of insuring that the maximum benefits available a crue to your beneficiaries;
3. To minimize various forms of wealth erosion, such as taxes, both now and in the future. Your estate-planning objective should be realistic. More importantly, your estate plan should be reviewed frequently and be flexible enough to accommodate unexpected changes in your financial and personal situation, as well as changes beyond your control.

Financial Consideration

You should try to create projections for the future direction of your affairs, including possible inheritances, asset liquation such as the sale of a business property, the paying of all mortgages, education costs for children, and opposition of recreation or retirement property. At the same time, you should attempt to assess how the economy performances might affect your assets and income in the future. One useful prediction tool is the “Rule of 72”. For example, if inflation averages 6% per year, one dollar today will be worth $0.50 in approximately 12 years (i.e., 72/6) and would be worth $0.25 in 24 years if the rate of inflation is 4% the same result will occur in 18 and 36 years respectively.

Preparing to meet your estate planning advisor:

A professional estate planner needs accurate and up to date information concerning your financial affairs, as well as clear understanding of your financial and personal objectives. He or she must be as well informed about your financial affairs as you are. Once you have selected the estate professional who will manage your estate plan, most often an accountant and or a lawyer (notary in Quebec), insure that you provide comprehensive information about your finances and future plans.

This includes providing:

- **A list of your assets and pairs,**
- **Mortgage documents and deeds,**
- **Shareholder and partnership agreement,**
- **RRSP and life insurance forms,**
- **Prenuptial and invested contracts, and**
- **Candidates to be your executor(s)**

An effective estate plan requires the cooperation and input of a number of individuals including your accountant, lawyer, insurance agent, financial advisor, and to some extent, your business associate(s). As with your overall tax plan, you should involve your spouse in the setting of your estate planning objectives. If your affairs are complicated and your spouse is expected to manage them upon your death as an executor, involving him or her makes good sense.

Planning Objectives

From a tax perspective, your estate-planning objective should be to:

1. Minimize and defer taxes now and in the future in order to preserve your accumulative wealth.
2. To shift any potential tax burden associated with a particular asset to your airs so that taxes become payable only when your airs eventually dispose of the asset
3. Minimize taxes at death so that as much as possible of you're accumulated wealth passes on to your heirs.

Your Changing estate plan

Your approach to planning for your estate will change through the varies stages of your life because your own estate plan will depend on your particular circumstances and those of your family, you can only out line general consideration. The following are intended as descriptions of difficult family situation.

Estate Planning Early in Life

During the period from your mid 20's to age 40, you will likely settle down and start a family, will have little in the way of substantial assets, and will be establishing yourself in your career or business. In this case, your goal is to protect your depends in the event that you or your spouse should die, or otherwise become unable to provide for them. At this age, it is like that, in your will, you would leave all your assets outright to your spouse.
Once you have more income you would want to start saving for future acquisitions, for your children's education, and for your retirement. These added expenses will also affect your estate planning.
At some point, you may be able to budget to pay the higher premiums to obtain the added security and investment benefits available permanent Life insurance.

Planning In Middle Age

From your 40's to your mid 50's you may well have more substantial assets as a result a larger family income. However you may also be facing increased expenditures, such as post-secondary education for your children. This is a good time to restructure business affairs and investments to reduce current taxes and facilitate accumulation of savings and other asset for your retirement.

Pre-Retirement Planning

Once you have reached your mid 50's, it is time to give serious consideration to planning for your retirement, if you have not already done so. You should continue with contributions to your pension fund through an RRSP or pension plan and you will probably continue to make additional investments. You might want to determine what type of retirement income will best suit your needs once your RRSP and pension plans have matured. If you have a business, you may wish to sell it to further supplement your retirement income, or create a succession plan in order to pass the management of it to others. The deemed disposition rules in the Income Tax Act, which impose a tax on unrealized capital gains at the time of your death, could seriously erode the value of you assets. However, you may be able to minimize the tax consequences of the deemed disposition rules through the careful disposition of your assets during your lifetime and within a

careful drafted will. You may want to consider gifting some of your assets to your heirs during your lifetime, or establishing trust for their benefits to take effect either during your lifetime or after your death.

Your Will

A will is a primary estate planning too. In fact without it you and your family will be completely unprepared to deal with your financial as well as emotional consequences of your death. The appropriate time for making a will is as soon as you have dependents to provide for.
When you create your will, you are the testator, if you are a man or the testatrix, if you are a woman. Your will, will appoint the executor(s) of your estate, name your beneficiaries, and create a distribution plan for your assets. It is important that you consult your spouse in the preparation of your will so that he or she understands the reasons for the provisions that are included if your spouse does not agree with the terms of the will, Provincial Family Law Status allow a spouse to claim to have the division of assets through supply that are provided upon the marriage breakdown this procedure can be expensive and protracted and you should try to avoid this outcome where ever possible. Communicating your wishes with your spouse beforehand and possibly drafting a domestic contract to deal with the division of assets can prevent such a challenge.

Choosing an Executor

The roll of the executor under a will involves onerous responsibilities. You should consider not only the willingness of the person to serve, but also his or her appropriateness for the position. Two of the major criteria are the familiarity of the person with your affairs and his or her technical and financial competence to manage your affairs.
The executor is often empowered by the provisions of your will to make virtually all decisions concerning your estate that you have not anticipated. These discretionary powers are especially important because your executor is charged with maintaining the value of your estate until assets are distributed to the beneficiaries. For example, if the executor believes your business would benefit from outside management help before your beneficiaries take it over, your will must empower him or her to undertake this arrangement. If these powers are not conferred, and your spouse or your children are incapable of managing the business once they gain control, there is little the executor can do but advise them to bring outside expertise, or perhaps advise them to sell the business before its value seriously declines.
Much of what happens to your assets after your death depends on the arrangements you have made before you die. If your instructions are not specific enough, your executor, although acting in good faith, may misinterpret your wishes or may have his or her powers contester in court.

Dying Intestate

Such laws vary from province to province to province. For example, the law in several provinces provides that if a person dies without a will, after the individual’s debts and liabilities are paid off, a reserve must be set-aside for the surviving spouse. The spouse receives an amount equal to the reserve and shares the balance with the children, if any. Since this type of distribution is arbitrary, in most circumstances it will not satisfy the wishes of the deceased or the needs of individual family members. Creating a will gives you the opportunity to make your own choices for the division of your assets.

Reviewing Your Will

A good rule of thumb is that your will should be reviewed, and revised if necessary, at least every five years. Your will should be revised immediately I the even of the death of an intended beneficiary or the executor, or because of changes in your family situation or financial circumstances. Quebec's Civil Code provides additional reasons why Quebec residents should have a professional review and, if necessary, modify their will.
Changes in the law may also affect the validity of your will.
For instance, in some provinces such as Quebec, legislation regarding division of matrimonial property will override the provisions of your will. Furthermore, legislation in most provinces (not including Quebec) provides that you may not totally disinherit your spouse or a dependant. Remember to have all the other parts of your estate plan reviewed, such as insurance policies and retirement savings and pension plans. When circumstances demand, remember to change beneficiary designations, or a substantial part of your estate may go to someone you may no longer wish to benefit.
To avoid pitfalls and difficulties with your will in the future, professional legal advice should be sought in all cases from lawyers (notaries in Quebec) experiences in wills and family law. Your tax advisor should also review the will before you sign it.

Taxation on Death

If you understand how taxation applies on death, you will be better equipped to decide how to provide effectively for the distribution of your assets in you will, and how to distribute assets during your lifetime, if that is your choice.
Technically speaking, there are no Canadian death taxes (estate taxes), federal or provincial, levied on the value of the assets that pass to beneficiaries. Only income amounts received (or deemed to be received) by the deceased and capital gains realized (or deemed to be realized) are subject to income tax.
Apart from income tax, however, each province levies fees called probate fees. These are charged to the estate of an individual as part of the process of receiving court approval for a will and appointment of an executor, or court approval for the appointment of an administrator, where there is no will. These fees are calculated on the basis of the value of the estate. While they vary between provinces, they can range as high as 1.5 percent. Probate fees are a debt that the estate must pay before the executor can take over and distribute the estate assets to the beneficiaries. Planning for these fees now will ensure that your estate and your beneficiaries do not face undue financial hardship upon your death.
Once the executor takes over administration of the estate, four distinct taxpaying entities may result: the deceased, the estate (during the estate settlement stage), any ongoing trusts created under the deceased's will, and, finally the beneficiaries.

Deemed Disposition Rules

In the year of death, an individual's taxation year runs from January 1 to the date of death. Your executor is responsible for filing a final return of income, known as the "terminal return." The terminal return must report all income earned form January 1 of the year of death to the date of death. Income includes interest, rents, royalties, annuities, remuneration from employment, and other amount payable on a periodic basis that were accrued but not due at the time of death, as well as amounts due but not paid. Also included are net taxable capital gains or losses realized prior to death and not included in income in a pervious year. A significant difference between the terminal return and a normal tax return is that the Alternative Minimum Tax, discussed below, is not applicable in the year of death.
In addition to actual earned or realized income, the *Income Tax Act* contains provisions that

create deemed income, which must be reported as income in the terminal return. Specifically, the deceased is deemed to have disposed of all capital property immediately before death for consideration equal to its fair market value immediately before death. These deemed dispositions can result in capital gains and losses, as well as a terminal loss or recapture of depreciation already claimed, which must be included in the terminal tax return.
"Recapture of depreciation" relates to capital property used to earn income. Taxpayers are entitled to claim a capital cost allowance (CCA) to offset the purchase cost of such capital property against the income earned through the use of the property. The *Income Tax Act* contains regulations that determine the CCA rates. If you sell or transfer capital property for a price greater than its depreciated value, you must account for that gain by including the excess amount as income (a recapture).
A large tax assessment on the "profit" from these deemed dispositions may result. Since there has been no actual sale of assets and thus no receipt of money, the estate may have difficulty paying any taxes that are levied.
If property of any kind is transferred by will to a spouse or spousal trust, no capital gains, recapture of depreciation, etc., arise on death, unless an election is made to claim such income. The spouse or spousal trust inherits the deceased's tax cost (i.e., acquired the property). Before choosing this method of relieving taxes, ensure that you have claimed any of your remaining exemption room in the $500,000 lifetime capital gains exemption. When a principal residence is transferred to a spouse or spousal trust, the spouse or spousal trust retains the deceased's principal residence exemption.
If you bequeath farm property, an interest in a family farm partnership, or shares in a family farm corporation to your child, grandchild, or great-grandchild in your will, there is a complete tax deferral on the transfer and the child assumes your tax cost. An election can be made to preclude full or partial deferral of tax, which increases the tax cost of the farm property for the child. Ensure that, during your lifetime or upon your death, you or your executor fully claims the $500,000 lifetime capital gains exemption.
These situations are commonly known as "rollovers." Your heirs assume any potential tax liability for the property, which will be payable only when they dispose of or are deemed to dispose of the property.

Optional Tax Returns

If the deceased was the proprietor of, or a partner in, a business, was a beneficiary of a testamentary trust, or had earned "rights or things" (which are generally unrealized income amounts at the date of death), the executor of the estate may have the option or reporting some of the business, trust, or "rights or things" income on three additional, separate returns.
Full personal tax credits can be claimed on each return, allowing for potential tax savings. The splitting of income amount the different returns then produces a further saving because of the graduated tax rate system.

Taxation of the Estate

Frequently, income-producing assets are held by the estate in trust before they are passed to specific beneficiaries. Generally, all income earned and received by the estate from the date of death is taxed in the estate. The main exceptions to this rule apply when income is payable or distributed to beneficiaries, or is elected to be attributed to a preferred beneficiary, in which case it is taxed in the hands of the beneficiaries.

Foreign Death Taxes

If you have any assets located in the United States, or if you or any of your beneficiaries is a citizen or resident of the United States, U.S. federal estate tax and state inheritance taxes may apply.
A recent amendment to the Canada-U.S. Income Tax Convention significantly changed the rules on death taxes with respect to U.S. property. If you own U.S. assets, consult with your tax advisor to determine what steps, if any, might be taken to reduce or eliminate the U.S. estate tax exposure. You should also note that foreign estate or death taxes will not be credited against provincial probate fees.

Planning Techniques

Often a “cost” is involved in implementing some of the estate planning strategies outlined below that goes beyond financial. A tax saving could be accompanied by loss of control over the related assets, or perhaps the overall flexibility of your estate plan will be impaired to some extent. The tools and techniques that you use depend on your personal and financial situation and your estate planning objectives.

Gifting

The most direct method of accomplishing the more common estate planning goals is to gift assets to your potential heirs during your lifetime. Since ownership is transferred, the future capital appreciation of the assets and the related future tax liability are also transferred. There are three drawbacks to gifting, however,

1. If the asset is transferred to your spouse or a related child under the age of 18, you will be subject to the “attribution rules.” In other words any investment income (i.e., interest, dividend, and rental income) earned on the property is taxed in your hands until the marriage breaks down (by death, divorce or separation or until the year the child turns 18. Also, when an asset is transferred to your spouse, the capital gain on the subsequent sale of such transferred property is attributed to you.

2. Since ownership of the asset is transferred, you lose control over the asset and you no longer have access to its future income-earning capability.

3. When you gift an asset to any person, except your spouse, during your lifetime, you generally are deemed to have received proceeds of disposition equal to the fair market value liable for any tax resulting from a capital gain.

As in the case of deemed dispositions that occur on death, there are certain exceptions to this deemed disposition inter vivo (i.e., during your lifetime) rule. You may be able to defer the tax via a rollover when:

- Property is transferred to a spouse or a spousal trust (although future capital gains and losses will be attributed back to you), or

- Farm property is transferred to a child, grandchild, or great grandchild.
  If you are a shareholder of a Canadian private corporation that uses all or substantially all of the fair market value of its assets in carrying on an active business primarily in Canada, or you won qualified farm property, you may be eligible for the $500,000 lifetime capital gains exemption on the disposition of shares of the company or farm. This exemption may be limited to $400,000 if

you have already taken full advantage of the $100,000 cumulative exemption for capital gains realized or deemed to have been realized on other property.
This strategy may not make sense if you are planning to sell the company to outsiders, however. It might be better to save the exemption for the arm's length sale, rather than use it for a "paper transaction" between family members. Keep in mind that this exemption may suffer the same fate as the $100,000 personal capital gains exemption.

Income Splitting

The primary objective of income splitting is to have income that normally would be taxed in your hands, at a high tax rate, taxed instead in the hands of a relative, usually your spouse or child, at a lower tax rate.

The Use Of Trusts

In its simplest form, a trust merely involves the holding of property by one person for the benefit of another person. In more technical terms, a trust is created when a settler transfers property to a trustee, who holds the property for the benefit of a beneficiary. A trust may be either testamentary (i.e. arising upon your death) or *inter vivos* (i.e., arising during your lifetime).
Trusts permit you to accomplish many of your estate planning goals. They may be used for such varied purposes as funding a child's education, providing for mentally or physically disabled children, or obtaining professional property management services.
Two conditions must be satisfied to achieve a tax saving. First, you must create a valid trust and relinquish ownership of the assets held by the trust, although, as trustee, you may still control the management and operation of the trust itself. Second, you must avoid the attribution rules. Because of the difference in the tax treatment of trusts, you must be very selective about the purpose behind creating you trust and the kinds of assets that you place in your trust. For example, if you intend to create a source of future income for your spouse and are considering transferring investment assets to a trust, you might also consider creating a self-directed spousal RRSP. A professional tax advisor can assist you in this choice.
If trust income is distributed to a beneficiary either directly through an actual distribution, or indirectly, as with the preferred beneficiary election (see below), such amounts are deducted from trust income and taxed in the hands of the beneficiary, assuming the attribution rules don not apply. This can result in some tax savings if the beneficiary is taxed at a lower marginal rate.
The *Income Tax Act* provides that certain forms of income earned in a trust retain their character when distributed to beneficiaries and taxed in their hands. For example, eligible Canadian taxable dividends received by a trust and distributed to a beneficiary make the beneficiary eligible for the dividend tax credit.

Preferred Beneficiary Election . . . When this election is made, income earned by the trust is taxed in the hands of the beneficiary; even though the income remains in the trust. For a trust's taxation years that end after 1996, this election is only available to a beneficiary who is eligible for the disability tax credit or an adult beneficiary who can be claimed as a dependant because of a mental or physical impairment. In addition, a preferred beneficiary must be a Canadian resident and one of the following:

- The settlor of the trust, or his or her spouse of former spouse;
- A child, grandchild, or great-grandchild of the settlor;
- The spouse (but not former spouse) of a child, grandchild, or great-grandchild of the settler;

- The settlor must also contribute more to the trust than any other taxpayer

The restriction of the preferred beneficiary election to individuals qualifying for the disability tax credit or qualifying for the mental or physical impairment credit has curbed the use of trusts for minor children. The Canada Customs and Revenue Agency (CRA) has granted some leeway, however. Many trusts empower their trustees to make payments to third parties for the benefit of the beneficiaries. Historically, the concern was that these payments would not qualify as payments to the beneficiaries and the trust would still be responsible for the tax. The C will allow third-party payments to qualify as payments to the beneficiaries if the payments are made at the request of the parent/guardian of the child. As a result, a family trust can be structured to pay the discretionary expenses for the beneficiaries while the parent(s) cover the basic necessities of life. Discretionary expenses include tuition for a private school, the cost of lesions, memberships, travel, etc.

They will also consider third party payments paid to cover the necessities of life as payable to the child in very limited cases. A trust may pay for the basic necessitates of life, either directly to a third party or through reimbursement to the parent/guardian. When calculating it's taxable income, the trust may claim a deduction on such payments and the minor beneficiary would include the amount of the payments and the minor beneficiary would include the amount of the payments as income. The parents would not attract any added tax liability, provided that the attribution rules do not apply. Because of the precise nature of these arrangements, seek professional advice on this issue.

Deemed Disposition Rule for Trusts . . . Special rules prevent trusts from holding property for an indefinite period. This restriction prevents the long-term deferral of capital gains from income. The general rule provides for a deemed disposition by a trust of all of its capital property every 21 years for proceeds of sale equal to the fair market value of the property. Because the rule is a deeming provision, the proceeds, which might only be on paper, will still affect the trust's tax position.

Estate Freezing

An estate freeze is generally undertaken when an individual owns assets that are likely to increase substantially in value over the long term and wishes to reduce the tax consequences. An effective freeze can eliminate or defer immediate tax in your hands, ensure that future growth of the asset will benefit your children, and allow you to maintain control of the asset.

An estate freeze is not a gift. If assets are gifted to a child, no value is received in return and control is lost. Under an estate freeze, you retain, or at least have access to, the current value of the frozen assets. Only the future increases in value are transferred to the child. It is also possible for you to retain control over those assets. Unlike estate freezing, gifting assets to your child eliminates tax on your death, but it also may result in an immediate tax liability, possibly outweighing the long-term benefits.

Direct Sale . . . Selling an asset to your child, the simplest of estate freezes, may achieve some or perhaps all of your estate planning goals. Tax is eliminated on death, but you must include any capital gain in income for tax purposes in the year of the sale. Normally, you would take back a note payable for the child as payment of the sale price. Through a direct sale, you can dispose of a growth asset and obtain a fixed-value asset in its place. You need not charge interest on the not; however, if your child is a minor, the attribution rules will apply to any income earned on the transferred asset.

With a direct sale, you can claim a reserve (i.e., not recognize the full capital gain) if you have not received all proceeds from the sale and the unpaid proceeds are not yet due. The taxable capital gain must be brought into your income over a specified period, depending on the type of asset

sold. Depending on the asset sold, when the reserve amount is included in income, it may be eligible for the $500,000 lifetime capital gains exemption.

The fact that you can demand partial or full payment on the note at any time may represent some form of control over the asset. Further, transferring the asset to a trust of which the child is a beneficiary may permit you to exercise more control over the asset if you are the trustee.
Corporate Freeze . . . For an asset freeze to be truly successful, the assets used must increase in value in the future and the more the better. As a result, the most common "frozen" assets are business assets. In particular, business assets in the form of shares of a private corporation controlled by the individual are often ideal for a freeze. Using a corporation in an estate freeze provides the individual with considerable flexibility and, if properly structured, enables him or her to achieve each of the estate freezing goals mentioned above.
Shares of foreign corporations may also qualify for the rollover provisions if an exchange of shares with a Canadian corporation or a merger took place after 1995. Although announced in November 1999 this amendment is still pending and you should consult with your tax advisor to determine whether an estate freeze is an option and an application for reassessment for your post-1995 returns is possible.

Taking Advantage of Tax Provisions

(A) Principal Residence Exemption

Detailed rules on the principal residence exemption are contained in Chapter 10. A number of estate planning options involve changes to the ownership of a principal residence.
If two residences are currently owned by a married couple (e.g., a city home and a summer cottage: the couple should consider transferring ownership of one property to adult children or grandchildren who reside in the residence for at least part of the year. The more common example involves transferring the cottage. This may involve a slight cost currently; for example, tax on the capital gain from the property that has accrued since 1981. Any future gain realized on the disposition of the other property retained by the couple will generally be tax-free under the principal residence rules.
Of course, if you sell or gift the cottage directly to the children you and your spouse no longer have any legal right to occupy it. Taking back a demand note as consideration on the sale may give you some control over the property, but perhaps not enough to suit your wishes. One solution might be to transfer the property to a discretionary trust for you and your children. The trust agreement could be structured to permit you to give the cottage to a particular child at some time in the future, while ensuring that the future increase in value accrues to the ultimate owner.

(B) Registered Retirement Savings Plans

RRSPs are probably the most common tax-deferral vehicles in use today. The immediate tax benefit of an RRSP is that it reduces annual income for tax purposes (within specified limits) by the amount of the annual contribution. The longer-term benefit is that an RRSP shelters the income accumulating in the plan form taxation.
For estate planning purposes, if you name a beneficiary in your RRSP, the assets in your RRSP will pass to the named beneficiary outside of your estate and will note be subject to probate. Further, if you name your spouse as your beneficiary, your estate will not incur any tax liability on the transfer to your spouse. Further, your spouse will be able to defer tax on the transfer if he or she transfers the assets to his or her own RRSP.

(C) Spouse and Spousal Trust Rollovers

If you bequeath capital property directly to your spouse or a qualifying spousal trust, the property can be rolled over (i.e., transferred) at your tax cost with no resulting taxation at the time of your death. For these spousal rollover rules to apply, certain criteria must be met:

- You must have been resident in Canada immediately before death.
- The ownership of the property must actually be transferred to your spouse or a qualifying spousal trust.
- If the transfer is to your spouse, he or she must have been resident in Canada immediately prior to your death.
- The spousal trust must be testamentary (i.e., created by your will) and must be resident in Canada when the property vests (i.e., property is fully transferred) in the trust.
- Vesting in the spouse or spouse trust generally must occur within 36 months of your death.
- If the property is transferred to a spousal trust, your spouse must be entitled to receive all the income during his or her lifetime and no other person may receive or have the use of any income or capital during his or her lifetime and no other person may receive or have the use of any income or capital during that period.

Your executor can undertake a certain amount of tax planning after your death. For example, he or she may elect that the spousal rollover provisions not apply to selected assets. This election will enable your executor to use previous years; losses and, if the election is made with respect to qualified property, your $500,000 capital gains exemption. Because all or part of the capital gains that have accrued up to the date of death are used through losses or the exemption, your spouse's future tax liability will only include any gains that accrue on the property after the transfer date.

(D) Life Insurance

Life insurance plays an important role in estate planning. I can be used for a variety of purposes:

- To provide a base for generating investment income to replace earnings;
- To accumulate as a tax shelter and provide a tax-free payout on your death to your beneficiaries, provided that it is properly structured;
- To help the surviving shareholder of a closely held corporation finance the purchase of shares from the estate of heirs of a deceased shareholder;
- To provide liquidity on death to cover the payment of income taxes and other debts and expenses;
- To provide additional assets to bequeath to children who are not involved in a family business. In the absence of the insurance funds, those children might otherwise receive shares of the family business, creating a possible disruption in the operation of the business.

  Your financial situation and the future needs of your family will dictate the type and quantity of life insurance you should have. While your insurance agent can provide you with details of the wide variety of individual policies available, bear in mind that there are two basic types of life insurance: term policies and permanent policies.

  The premiums of a term policy are generally less expensive for a younger person, but there are a number of disadvantages. For example, you receive no benefits if either you or the insurer cancels the policy. There is usually no obligation for an insurer to continue coverage, and the policy likely will not be renewed beyond a certain age. Of course, insurance companies now offer many variations on the term policy that have additional features, such as options that guarantee your insurability to almost any age.

  While a permanent policy (often referred to as a "whole life" or "universal" policy) initially involves higher premiums, it has the advantage of also serving as an investment vehicle. For example, you can usually borrow against your insurance savings at a favorable rate, and you may receive a lump sum if you decide to cash in the policy at a future date. Most permanent policies are structured so that accruing income is not taxed annually; however, borrowing against the cash

surrender value or “cashing in” the policy could result in tax.
Insurance arrangements involving the purchase of a deceased shareholder’s shares by the surviving shareholders are more complex and require careful planning.

Succession and Estate Planning for Business Assets

If you are a business owner or have an interest in a business, this asset could be your largest source of current as well as retirement income. Converting your business interest into retirement income requires the implementation of a succession plan. You may foresee eventually transferring control of the business to your children, or you may wish to sell the business to a partner or third party on your retirement, or arrange for professional management while ownership remains with your family. Whatever your goals, be aware of the planning techniques that can result in substantial tax savings for you and your family.
Most financial planning, including tax and succession planning, involves incorporated businesses. If your business is not incorporated, but can be, discuss the situation with professional advisor to determine if you would benefit from such a change in business structure.
Before choosing the planning techniques best suited to you, consider a number of factors such as the abilities of your spouse and/or children to manage the business, the level of their participation in control and ownership, the timeframe for transfer of control, the role of key employees, and your won financial needs after retirement.

Exemption of Tax on Capital Gains on Shares of Small Business Corporations

The deemed disposition rules consider capital property, including shares, to be disposed of for proceeds equal to fair market value immediately before death. As well, on the gifting of the shares to anyone other than you spouse, you are deemed to receive proceeds of disposition equal to the fair market value of the shares.
If the value of the business has increased significantly over the year, a large capital gain will generally result from the transfer of the corporation’s shares. If the capital property qualifies, such a gain is eligible for the lifetime $500,000 capital gains exemption. If you owned capital property prior to 1994, you may already have claimed the $100,000 personal capital gains exemption. In this case, your lifetime exemption is restricted to $400,000. This exemption applies to gains realized on the disposition of “qualified farm property” or “qualified small business corporation shares, “ terms defined in the Income Tax Act. Generally speaking, if your business is an active business carried on primarily in Canada, and at least 90 per cent of the fair market value of assets of the corporation are used in the business, chances are that it would qualify for the $500,000 capital gains exemption. If you spouse owns part of the small business corporation, he or she also has $500,000 exemption, which means that tax on up to $1 million of capital gains may be eliminated. If the gain is realized in one year, however, you may be subject to Alternative Minimum Tax (AMT) on the “untaxed” part of the gain.

The Alternative Minimum Tax . . . The AMT is an alternative method for calculating income tax. It was created in 1986 to prevent high-income Canadians from sheltering taxable income with deductions, credits and shelters. The AMT should always be considered in tax planning, particularly if the taxpayer has claimed a rollover or where a significant capital gain has occurred. You must calculate your taxable income using both the regular and AMT methods for the current year and pay the greater tax amount. Under the AMT, the untaxed portion of any capital gain is added back. Some relief is available if you can claim that the income or deduction that gave rise to AMT was a result of timing. Any overpaid AMT can be carried forward seven years against your future tax liability to the extent that regular income tax exceeds AMT. In addition, AMT does not apply in the year of death.

Since 1998 and retroactive to 1994, the AMT has not applied to registered pension plan (RPP) and registered retirement savings plan (RRSP) contributions. Taxpayers who are planning to

make catch-up contributions to their RRSPs will benefit. No retroactive adjustment will be made for taxpayers who became non-residents or bankrupt before 1998.

Rollover of Farming Property

To encourage children of farmers to continue to operate the family farm after their parents' retirement or death, special rules permit the transfer of farming assets from one generation to the next without incurring a tax cost. Similar rollover rules also apply to the transfer of shares of a family farm corporation (or a holding corporation that owns such shares) and to the transfer of an interest in a family farm partnership. Also, the $500,000 capital gain exemption is available for gains realized on the disposition of qualified farm property, to the extent that it has not been used to shelter gains from the disposition of qualified small business corporation shares.
Rollover provisions do not eliminate taxation, but merely postpone the taxation of a gain. However, transferring the property under the lifetime exemption will increase the child's tax cost of the property, resulting in a smaller capital gain when the child does dispose of the property. The child may use the $500,000 lifetime exemption when the property is sold to shelter future gains, provided the exemption still exists at that time.

Estate Freezing Techniques for Corporate Assets

After deciding on the objectives that best suit your estate planning needs, particular techniques must be chosen that will achieve your intended objectives with the optimum tax advantage. The techniques briefly discussed below all involve "freezing" the present value of your business so that all or part of the future growth and the resulting tax consequences are deferred to your heirs. These techniques may also be used, however, to freeze the value of almost any assets having inherent taxable capital gains.
Recall that an estate freeze is a method of organizing your affairs to permit any future appreciation in the value of selected assets to accrue to others, usually your children, and not to you. From your tax perspective, the value of the asset is frozen on the day of the transaction. Because these freezing techniques involve corporate assets, seek professional advice before undertaking any of these strategies.
The choice of technique used to freeze the assets will depend on a number of considerations, Including:

- Nature of the assets to be frozen;
- Size of the estate;
- Extent of control you wish to exercise over the frozen assets;
- Number of parties to be involved in the freeze
- Immediate tax cost, if any, that might result from the freeze, taking into account the $500,000 lifetime capital gains exemption on qualified property;
- Your tolerance for complexity in your financial arrangements;
- Professional fees that will be incurred; and
- Degree of flexibility and reversibility ty desired.

The following discussion assumes that your active business assets are owned by a corporation controlled by you. In general, the corporate structure facilitates effective succession and estate planning. If your business assets are not held by such a corporation, it is usually a relatively simple matter to arrange a transfer under professional guidance.

(A) Direct Sale

Perhaps the simplest method of freezing your interest in shares of a privately held company is to sell the shares directly to your adult children. In the most common scenario, the sale would take place at fair market value, and you would take back a promissory note for the balance of the sale price not received in cash. There should be an agreement of purchase and sale that outlines the details of the sale, such as terms of payment, the due date of any unpaid amount, whether the unpaid balance is subject to interest, etc. Although it is not necessary to charge interest on the unpaid balance owed by your children, you should be aware that the attribution rules will apply if no interest is charged because the arrangement occurs between non-arm's length parties.

There are some disadvantages to a direct sale. First, you will be taxed on any capital gain realized in excess of any gain eligible for your $500,000 lifetime capital gains exemption. You also may become subject to the Alternative Minimum Tax. However, you may claim a reserve (i.e., exclude from income) on a portion of the taxable gain if you do not immediately receive all proceeds of disposition. When amounts claimed under the reserve provisions are eventually brought back into income for tax purposes, they will be eligible for your $500,000 lifetime capital gains exemption. Remember that even if you gift the shares to your children, you will be deemed to have received proceeds of disposition equal to the fair market value of those shares.
A second disadvantage of a direct sale is that you could lose control of the business if sufficient voting shares are sold to your children. This obstacle may be overcome if you subscribe for new voting preferred shares that carry more votes than the existing common shares. Alternatively, you may be able to exercise some control by placing the common shares in escrow (i.e., maintaining possession and control of them) until the demand note has been entirely paid off.
Another disadvantage of a direct sale accompanied by a promissory note is that, unless cash is paid for the shares, the amount owing to you remains in the corporation and may therefore continue to be at risk. To avoid this, have your children take out a loan to pay for the shares, rather than accepting a demand note from them. Accepting the full payment would necessitate recognizing the entire capital gain almost immediately for tax purposes, however, as well as risking the triggering of the Alternative Minimum Tax. As a compromise, the consideration could be part cash (from the outside loan) and part note (from the children)

(B) Sale to a Holding Company

A common method of freezing the value of shares in an existing company involves the use of a new holding company specifically set up to acquire such shares. The children involved in the freeze would incorporate a company and acquire all its common shares for a nominal amount. You would transfer your shares in the operating company to the newly incorporated holding company, which generally can be done on a tax-deferred basis. You would take back voting preferred shares (with a value equal to the shares transferred into the holding company) in the new company as consideration for the transfer.
To avoid this possibility, the parent could acquire all the common shares of the holding company as well as the preferred shares. The parent would then gift the common shares to his or her children. Making a gift excludes the common shares from the matrimonial property of the married child in most cases, because assets inherited or received by way of gift are excluded from matrimonial property. In Quebec, shares of a private or public company are not included in matrimonial property. In certain provinces, an appropriately worded deed of gift can also exclude

from matrimonial property any income derived from the gifted property (such as dividends on gifted shares).
Any future appreciation in the value of the business operations now accrues to your children.
You could retain control of the operating company by holding voting preferred shares in the holding company. This permits you to set dividends and an reasonable salary according to your income requirements and allows you to run the business much as you did before.
One disadvantage of the use of a holding company in an estate freeze is that a capital gain or deemed dividend may arise on the redemption or disposition of the preferred shares (that you acquired as consideration for the transfer of your shares) during your lifetime. All or a portion of the capital gain could be exempt under your $500,000 lifetime capital gains exemption, however, if the shares were considered qualified property at the time of redemption or disposal. It might be necessary to obtain a professional valuation of your shares.

(C) Asset Freeze

As an alternative to transferring the shares of an operating company to a holding company, consider freezing the value of these shares by selling the underlying operating assets to a new company incorporated by your children. This method of estate freezing may involve considerable work and expense, and sales or other transfer taxes could result. However, in some situations an asset freeze is the best approach. It works well if you own a multifaceted business and you want to break it up into separate corporations, each to be owned by one child.

Internal Freeze . . . It may be possible to reorganize the existing share capital structure of your company to accomplish an estate freeze. Where applicable provincial or federal company law permits, you any exchange all your existing common shares for voting preferred shares of a certain type. After the exchange, a new class of common shares would be created and purchased by the children at a nominal amount. The result of this type of reorganization is that you freeze the current value of your holdings in the operating company, and your children participate in the future growth in value of the company through their ownership of common shares. This type of freeze is relatively simple, does not require a new corporate entity, and provides you with preferred shares that should give you a fixed income through dividends, if desired. Of course, as with other freezes where no cash is received, there is always the problem that the money owed to you is tied up in the corporation and therefore exposed to some risk.

Choosing the Best Freeze Vehicle . . . The freeze vehicle chosen should not be based solely on income tax considerations. For example, a partial estate freeze should provide better protection from future inflation than a complete freeze. In all cases, consult your professional advisor before making a final decision. An estate freeze requires careful planning, not only because of the tax consequences involved, but also because it may be difficult to thaw (i.e., unwind).

(D) Sales to Third Parties

If you own a business, you may consider transferring it to unrelated parties, such as other shareholders, partners, or key employees, rather than to your children or spouse. Your spouse or children may be unable or unwilling to run the business, or the partners or other shareholders may not want the children involved.
Selling your shares to your fellow shareholders will ensure that the company remains private and thus eligible for the small business tax benefits.
Arranging a sale to employees may bind your best employees to the business, relieve you of some management headaches, as you get older, and assist in an orderly transfer of ownership.
A sale could be coupled with a long-term employment contract should you wish to remain involved in the company.

(E) INSURANCE

Insurance arrangement for business purposes are complex and require careful planning. The purpose of business insurance in the context of estate planning is to ensure that sufficient funds are on hand at your death for the business to be dealt with in accordance with your wishes. Depending on your estate plan, a properly constructed insurance plan will ensure that your estate has sufficient liquid assets on had to pay tax on any taxable capital gains realized on your death. Furthermore, such a plan will enable your partner or another shareholder in the corporation to purchase your share of the business upon your death, if that is your wish.

(F) BUY-SELL AGREEMENTS

A buy-sell agreement is basically a contract between business partners or shareholders of a corporation. It is frequently used in estate planning to extend to surviving shareholders the right or obligation to purchase the shares of a deceased shareholder. It is advantageous both for surviving shareholders, who may not want a stranger to buy into the corporation, and the family of the deceased, who might otherwise have difficulty selling the shares

The spousal rollover rules are not applicable to shares that are subject to a compulsory buy-sell agreement. Tax is paid by the deceased shareholder in the terminal tax return on any resulting capital gain if the $500,000 lifetime capital gains exemption cannot be3 fully used. If the buy-sell agreement is structured in such a way that the surviving shareholder has an option to buy, and the surviving spouse has an option to sell the shares can first pass to the spouse on a rollover basis. Any capital gain arising on the subsequent sale of the shares by the spouse would be recognized in his or her hands. The gains would, however, be eligible for the spouse's own $500,000 lifetime capital gains exemption, if it is still available and provided that the shares are qualified shares at the time.

Whichever buy-sell method is employed, one thing remains certain—unless there is some method of funding the transaction, the agreement may not be consummated. It is common for life insurance to be used to provide the funds to finance the sale, and there are three common methods of employing life insurance as the funding mechanism for a buy-sell agreement.

- **Criss-Cross Insurance** . . . This is an insurance arrangement where each shareholder of a corporation acquires a life insurance policy on the life of each other shareholder. On the death of one shareholder, the survivors received the tax-free proceeds of the policy and use the funds to purchase the deceased's shares from his or her estate or beneficiaries. One disadvantage of this method is that the cost of the insurance to each shareholder can vary widely depending on the ages and health of the other shareholders.
- **Corporate-Owned Insurance . . .** With this type of policy, the corporation insures the lives of its shareholders and receives the proceeds on their deaths. The advantage of this method is that the corporation pays all insurance premiums and the cost to the shareholders is shared in proportion to their shareholdings. The proceeds are used by the corporation to purchase the deceased's shares, either from the deceased's estate or from the surviving spouse. Generally, neither the deceased nor the spouse will be subject to tax on the buyback if the arrangement is properly structured. Specifically, the surviving shareholders will avoid an increase in the cost base of their shares upon redemption, which in effect means the deceased shareholder's gain has been transferred to them. This situation could be compensated for by reducing the redemption price so that more cash is retained in the corporation or by increasing the amount of the insurance coverage. The legislation is complex, however, and, in spite of some protective measures, the deceased could be subject to tax. Existing succession plans should be reviewed to see if they qualify for the protection, while business reorganizations should be structured to alleviate the impact of the new rules. Obtaining professional advice is strongly recommended.

• **Split-Dollar Insurance** . . . Split-dollar insurance is a combination of both criss-cross and corporate-owned insurance. Each shareholder purchases a whole-life type of policy on the other and assigns the cash value of the policy to the company. On the death of a shareholder, the company receives the cash value of the policy while the surviving shareholders receive the face value less the cash value, and use these proceeds to purchase the shares. The advantage of this method is that the company pays most of the premiums.

The use of buy-sell agreements, combined with life insurance funding, should be considered where shares of private companies are owned and two or more shareholders are dealing with each other at arm's length and also in some non-arm's length situations. In all cases, the insuring method employed should not be chosen without the assistance of a professional advisor.

For more information please contact us at info@spgaccountants.ca