



# Tax Alert

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## *Transferring Wealth: Effective Strategies for the Typical Canadian*

### *Keeping it in the family*

You've worked a lifetime to accumulate assets. In fact, the average Canadian family has amassed total personal wealth of approximately \$224,633.<sup>1</sup> And whether your nest egg is bigger or smaller than that, there are simple strategies you can use to make sure your wealth passes smoothly and tax-effectively to your children and grandchildren.

### *Minimize capital gains taxes on your cottage*

For many older Canadians, the family cottage becomes a liability. Maintenance expenses are a drain on bank accounts, and the equity tied up in the cottage could be put to better use funding retirement, dream vacations or hobbies. Transferring your cottage to the next generation during your lifetime may solve these problems and provide tax-planning opportunities at the same time.

Imagine that you have a home in the city that you intend to designate as your "principal residence."<sup>2</sup> You can sell this home without paying tax on the capital gains it has earned through the years. Your cottage, on the other hand, will not be exempt from capital gains taxes when you sell it. However, if you expect the cottage to appreciate in value in the coming years, transferring ownership to your children now allows all future gains to be taxed in their hands rather than yours. It also means there will be no probate fees on the value of the property after your death because the cottage will not be part of your

estate.

Of course, selling the cottage now does mean that taxes will be due on any appreciation in value to this point. However, there are smart ways to structure the sale to reduce the immediate tax liability. If you sell the cottage to your children in return for a mortgage or a promissory note (though not a demand promissory note, which is deemed to be due immediately), with equal payments to be made over a minimum of five years, only 20 per cent of the capital gains must be reported each year. Essentially, you can spread the taxes over five years. Then, if you so choose, you can forgive the outstanding loan in your will.

### *Maximize the benefits of your RRIF*

It is very important to name a beneficiary for your Registered Retirement Income Fund (RRIF), and to choose that beneficiary wisely. Like a Registered Retirement Savings Plan (RRSP) and Registered Pension Plan (RPP), an RRIF can be paid directly to a named beneficiary, thereby avoiding probate fees.

In addition, if the RRIF beneficiary is a "qualified beneficiary" (a spouse, common-law partner, financially dependent child or grandchild, or a child or grandchild dependent because of physical or mental infirmity), the RRIF proceeds can pass tax-free directly into the beneficiary's RRSP or RRIF, to be used to purchase a qualifying annuity.

Proceeds from an RRIF left to someone other

than a qualified beneficiary will be included and taxed as income on your final tax return, and the bill could be hefty. While you can prepare to cover these taxes in advance with a life insurance policy, it is often preferable to leave RRIF assets to a qualified beneficiary and leave other non-registered assets to your other beneficiaries.

### *Spread out an inheritance using an Annuity Settlement Option*

Providing beneficiaries with lump-sum payments of their inheritances may not be desirable in every situation. For example, if your children are still growing up you may be worried that they might not be able to handle a large amount of money responsibly. Trusts allow you to define how much is paid and when, but they can be costly and complicated. You have another, simpler option.

Investments offered by insurance companies, such as Guaranteed Interest Contracts (GICs) and segregated fund contracts, provide an annuity settlement option.

These investment opportunities allow you to specify that beneficiary payments be made as a lump sum or spread over a defined period of time (for example, for a specific term such as five or ten years, or for life with an optional guarantee period or cash refund option). You can also combine these options and arrange for beneficiaries to receive part of their inheritance as a lump sum and part as regular income over time.

### ***Avoid probate fees with insurance investments<sup>3</sup>***

As long as you name a valid beneficiary on your insurance investments, they will be dealt with outside your will. They will not form part of your estate and therefore will not be subject to probate fees or estate administration costs, and may be protected from any creditors you might have at the time of your death.<sup>4</sup>

Investments offered by insurance companies can provide additional benefits. If you name a valid beneficiary, your investments will avoid probate, which can take several months or even years if the will is challenged, and provide direct payouts to your beneficiaries. Generally, they also provide maturity and death benefit guarantees, meaning that upon your death, and subject to certain conditions, your beneficiaries will be entitled to receive a guaranteed sum regardless of the market value of the investment at that time.

Furthermore, investments offered through insurance companies are flexible; it is easier to change a beneficiary designation than it is to change a will. You also have the option of naming a trust as a beneficiary, which may qualify as a testamentary insurance trust. These are taxed at the same graduated tax rates as individuals.

### ***Watch out for U.S. estate taxes***

Many Canadians are not aware that holding property situated within the U.S. may subject their estates to U.S. estate taxes. U.S. properties include U.S. real estate, shares of U.S. corporations (even if they were

purchased through a Canadian broker or a Canadian stock exchange), and business interests located in the U.S.

While Canada taxes estates only on income and accrued capital gains up to the date of death, the U.S. taxes individuals on the total value of their estates. Thus, U.S. estate taxes can be significant. The good news is that people with U.S. assets worth less than US\$60,000 are exempt altogether, and people with worldwide assets worth less than US\$1,200,000 are subject to U.S. estate taxes only on their U.S. real estate and business interests.

### ***Strategies for small business owners***

If you own a business, speak with your financial advisor about the many wealth transfer strategies that can minimize taxes and maximize the value of your company when it passes to your children or grandchildren. Here are some ideas to get you started:

- Make full use of your lifetime \$750,000 capital gains exemption.<sup>5</sup>
- Consider an estate freeze, which allows you to retain control over the business while freezing the value of your interest in the company so you can pass future growth on to the next generation.
- Think about purchasing life insurance. It can help fund an anticipated tax liability in your estate to keep the company afloat while your beneficiaries search for a buyer or reorganize the management team.

### ***A little planning goes a long way***

Every Canadian should have a comprehensive plan for transferring assets to the next generation, no matter how big or small his or her estate may be. Your financial advisor can help you implement strategies that work for you - whether that means moving property or investments into your beneficiaries' hands now or structuring assets so the transfer is tax-efficient upon your death. Careful planning, starting today, will help you minimize taxes, reduce the possibility of a forced sale to cover unanticipated estate costs, and, perhaps most importantly, avoid family conflict and challenges to the wishes you express in your will. Contact your Collins Barrow advisor to discuss the appropriate wealth strategies for you.

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- 1 Source: Vanier Institute, January 2005.
- 2 A taxpayer can only designate one qualifying property as his or her principal residence for a particular tax year, and for years after 1981 only one property per family unit can be designated as a principal residence.
- 3 Probate is not applicable in Quebec.
- 4 In Saskatchewan, jointly held property and insurance policies with a named beneficiary are included in the application for probate but do not flow through the estate and are not subject to probate fees.
- 5 Available on the sale of certain qualified small business corporation shares.

## ***Ensuring a Solid Family Tax Plan***

Family tax planning, taken lightly, can be dangerous ground for the unprepared taxpayer. It is essential to structure any arrangement with family members carefully in order to avoid the many pitfalls.

When family members purchase shares in a family company, it is important that they actually *pay* for the shares. The share subscription is the foundation of every other

transaction that follows. On a number of occasions, the Canada Revenue Agency (CRA) has exploited the fact that money did not change hands, or that funds from an existing shareholder's account were used, and refused to recognize the transaction as a legitimate share transfer. As a consequence, the attribution rules were applied to attribute the income to the spouse or parent. As with any other share purchase,

the individual must pay for the shares with his or her own funds, or with properly structured loans that follow specific exceptions to the attribution rules.

In order to pay a dividend to a family member shareholder, the directors of the company must genuinely pay the money, either by actually writing a cheque or by showing that a note payable was formally

accepted in full payment. The funds generally should be deposited into a bank account solely under the control of the adult recipient. For a minor child receiving larger sums, this is best accomplished using a formal trust arrangement. In Ontario, under the *Children's Law Reform Act*, a person can pay funds up to \$10,000 in the aggregate to a parent, who is then responsible to account directly. The parent should keep the funds in a distinct account.

Trustees of discretionary trusts may wish to make trust payments directly to third parties for the benefit of the beneficiary. It might make more sense to pay a parent or third party directly for reimbursement of a child's expenses. The CRA administratively accepts such, provided:

- the trustee acted within the confines of the trust agreement;
- the amount withdrawn will be declared as

income to the child; and

- the payment was a reasonable expenditure made for the benefit of the child.

Every payment must be documented properly. The trustee and parents may be required to provide evidence of the transactions to the CRA in the future.

The recent decision of the Tax Court of Canada in *Demers v. The Queen*, 2007 DTC 30, is a lesson on point. The taxpayer's problems began with the infant daughters not paying for their shares. The plan was further compromised when the parents, presumably acting as guardians of the infants, agreed to sell the shares to the father on a specified date ten months later. They made the agreement the same day they purchased the shares. Finally, the \$12,000 dividend to each child was in fact deposited into the father's bank account and used by him. The father

argued the funds were loans that were subsequently paid back with RESP contributions, but he could not provide any evidence of a written agreement to support this claim. In the end, Mr. Justice Dussault ruled that the entire matter was a sham and ordered the dividends paid to be attributed to the father and included in his income.

Careful family tax planning is important. Ensuring the desired effect of transactions requires care to ensure that the factual and legal reality is consistent with the general objectives. Given the potential for disastrous and costly consequences, it is prudent to seek out competent, knowledgeable professionals to guide the plan and ensure it stands on a firm foundation.

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## ***Estate Planning - the Finer Points: Special Issues for Those with Special Needs***

Children with special needs raise special issues. If you have such children, a proper estate plan will help to ensure their financial well being, and that of your entire family. There are four important issues in completing your estate plan: equality or equity; liquidity, trust, and flexibility. Unfortunately, however, the special needs tax system is very complex and there remain gaps between federal and provincial systems.

### ***Equality or equity***

If you have more than one child, the issue of how to treat all of the children must be addressed first. Will they be treated *equally*, or will they be treated *equitably*? In making decisions, it is important to familiarize yourself with the tax and benefit systems, both federal and provincial.

The tax systems deal with special needs children differently from other children.

Important credits may be available to supporting parents. Most importantly, the balance of the RRSPs or RRIFs, which are usually fully taxed on the death of the last parent, may in some cases be transferred to the special needs child without tax. This can be of enormous benefit. For example, if a deceased single mother had \$200,000 in RRSPs, the tax payable on her death would be about \$100,000. If the special needs child is the ultimate recipient of the RRSPs, the \$100,000 in tax can be deferred, and possibly saved outright, if the special needs child has no other taxable income. These funds may be structured in a "lifetime benefit trust" in the case of mental infirmity, for the exclusive benefit of the child during his or her lifetime.

The *Income Tax Act's* more restrictive definition of "mental and physical impairment" must be met to qualify for some of these important benefits. The impairment(s) must be severe and

prolonged. The effects of the condition, or the cumulative effect of the conditions, must be such that the ability of the individual to perform a basic activity of daily living is markedly restricted. The recent federal budget expands the category to include individuals who would otherwise meet the requirement but for therapy that is administered at least 3 times per week for a



total period averaging not less than 14 hours per week. A certificate from a physician or other qualified professional is required. However, in other cases such as the RRSP rollover above, a less rigid test of dependency due to physical or mental infirmity suffices.

The financial needs of the special needs child must be assessed carefully. Will the inheritance be enjoyed? Will it make a difference to that child's quality of life? The *Ontario Disability Support Plan Act* (ODSP) and other similar provincial plans may provide for an ongoing monthly pension. An inheritance can affect the benefits. Present simplified rules for bequests of less than \$100,000 allow the beneficiary to receive \$5,000 per year in addition to approved disability expenditures, over and above the monthly pension, from a trust funded by the inheritance. However, any inheritance greater than \$100,000 will directly reduce the pension. Funds that are left in reserve in purely discretionary trusts will not reduce the pension until applied to the benefit of the person. This rule was settled by an Ontario Court of Appeal decision called "Henson," and such trusts are commonly referred to as Henson Trusts. Unfortunately, there is some uncertainty as to whether a lifetime benefit trust receiving an RRSP balance will qualify as a Henson Trust for ODSP purposes.

### **Funding the estate plan**

After you have determined the present and future financial needs of your challenged beneficiary, and decided what your estate

objectives are amongst all of your children, next you need to determine the means and liquidity of the estate. While considering this issue, it is important to consider the expenses and income taxes payable on the settlement of your estate. This is not an exact science. Tax rates can change. Tax rules can change. It is thus prudent to be conservative with your estimates. Ask yourself: Am I leaving a sufficient estate to meet my objectives for my special needs child and the rest of my family? At this time, you might consider establishing a savings plan or purchasing life insurance.

The Registered Disability Savings Plan (RDSP) is a new option for individuals who qualify for the disability tax credit. RDSPs are tax-sheltered savings plans. The lifetime maximum contribution for each child is \$200,000 and can be made until the year in which a beneficiary turns 59. RDSPs are eligible to receive both Canada Disability Savings Grants and Canada Disability Savings Bonds until the end of the year in which the beneficiary turns 49. The principal amount is not deductible, but the accrued income is taxable in the hands of the beneficiary when withdrawn. Unfortunately, the effect an RDSP will have on ODSP pensions has not been determined. There is similar ambiguity in other provinces. Until this effect is clarified, use of RDSPs generally is not advisable.

### **Flexibility**

No estate plan, no matter how comprehensive, can ever include *all* variables that might occur over time, both before and

after your death. Therefore, the most important aspect of your plan is that it be flexible. The value and nature of your assets might fluctuate. Your special needs child might or might not qualify for special tax status at the time of your death. Government assistance to challenged beneficiaries might waver. Your children's needs are not static. Your estate plan must make good sense if you die tomorrow, but it must also endure the test of time.

### **Trust**

During the estate planning process you will be required to name a trustee to administer your affairs upon your death. You are entrusting this person with the obligation to ensure that your estate plan unfolds as it was intended. A good estate plan will permit the trustee to adjust your plan to accommodate circumstances as they arise. Who will you name? Is one person sufficient, or do you wish to name more? Is a professional or trust company appropriate?

### **Conclusion**

Families with special needs children face many challenges. A proper estate plan can help to provide financial security and peace of mind for the present and the future. Quality tax and legal advice are critical for any proper estate plan. Contact your Collins Barrow advisor for help.

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