The Long Game - Tax Considerations for the Estate Planner

Presentation to the Fraser Valley Estate Planning Council – May 16, 2017

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Tonight's Agenda

A. Playing the Long Game
B. Today's (Investment/Legal/Valuation/Tax) Environment
C. Current Tax Policy Considerations
D. Voting and Discretionary trusts
E. Alter-ego and joint partner trusts
F. Spousal trusts (inter-vivos)
G. Graduated rate estates
H. Spousal trusts (testamentary)

Playing the Long Game

The Estate Planning Process

- ❑ When does it start? At retirement?
- ❑ When does it end? Plan approval?

The Planning Horizon

- ❑ Life expectancy 1930-1932 (60M/62F)
- ❑ Life expectancy 2007-2009 (80M/84F)
- ❑ Life expectancy (age 65) (85M/87F)

Playing the Long Game

30 Years Ago (1987) – Where were we?

- The DJIA closes above 2000 for the first time
- Aretha Franklin becomes first women inducted into the Rock and Roll Hall of Fame
- Regan tells Gorbachev to tear down Berlin Wall
- Canada introduces the "Loonie"
- Canada-US Free Trade Agreement reached
- Black Monday sees DJIA fall 22.6% in one day
- Release of 1987 White Paper on Tax Reform

Playing the Long Game

Thirty Years From Now – Where will we be?

- ❑ Globalization?
- ❑ Immigration?
- ❑ Demographics?
- ❑ Automation?
- ❑ Capital market conditions?
- ❑ Labor market conditions?
- ❑ Tax policy?

Playing the Long Game

How do you play the "Long Game"?

- Recognize that we are living in an era of unprecedented change
- Recognize that, as a society, we face very significant challenges going forward
- Ensure the design of your estate plan is focused around one key objective – flexibility
- **Obtain maximum flexibility (while retaining control) through the use of discretionary trusts (which provide for "ownership uncertainty")**

Today's (Investment) Environment

Important to appreciate the extent to which private companies now have a significant and increasing role in the economy

- In 2009, for instance, accounting firm Grant Thornton issued, "A wake-up call for America," which focused on the "systemic failure in the U.S. stock markets." The report notes that the number of companies listed on either NASDAQ, the NYSE or AMEX dropped by about 22 percent, from 6,943 to 5,401, between 1991 and 2008. When adjusted for GDP, the decline was even more significant: down by nearly 53 percent.
- Source: http://businessfinancemag.com/tax-amp-accounting/public-companies-decline-or-not

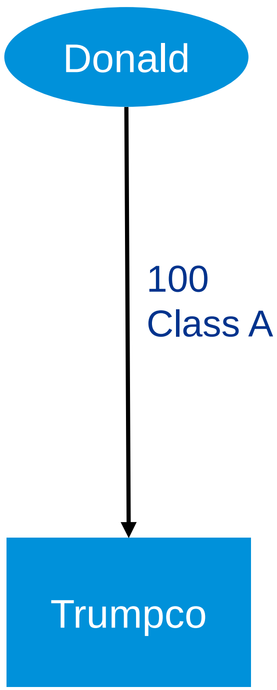
Today's (Legal) Environment

Authorized share capital for private companies are significantly different from that used with public companies:

- Multiple classes of shares
- Ability to pay dividends on one class of shares to the exclusion of one or more other classes of shares (i.e., discretionary dividend shares)
- Ability to have voting shares that are non-participating with respect to dividends
- Supreme Court has considered two cases involving discretionary dividend shares

Today's (Valuation) Environment

What are the valuation implications associated with discretionary dividend shares?



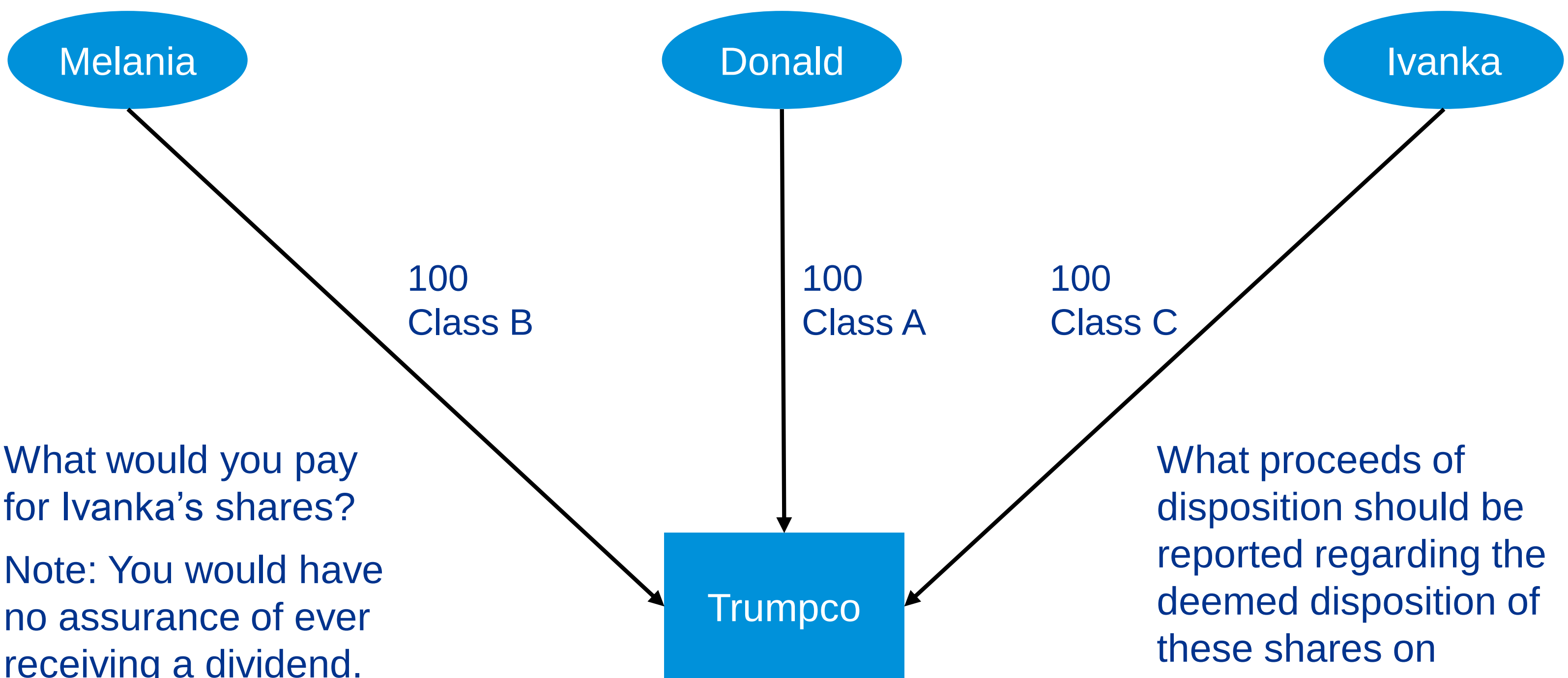
In this situation, there is only one class of shares issued and outstanding (no discretion to allocate).

All corporate distributions will be paid to the Class A shareholders.

The fair market value of the company's shares as a whole (the "en-bloc value") can be reasonably estimated.

Today's (Valuation) Environment

What are the valuation implications associated with discretionary dividend shares?



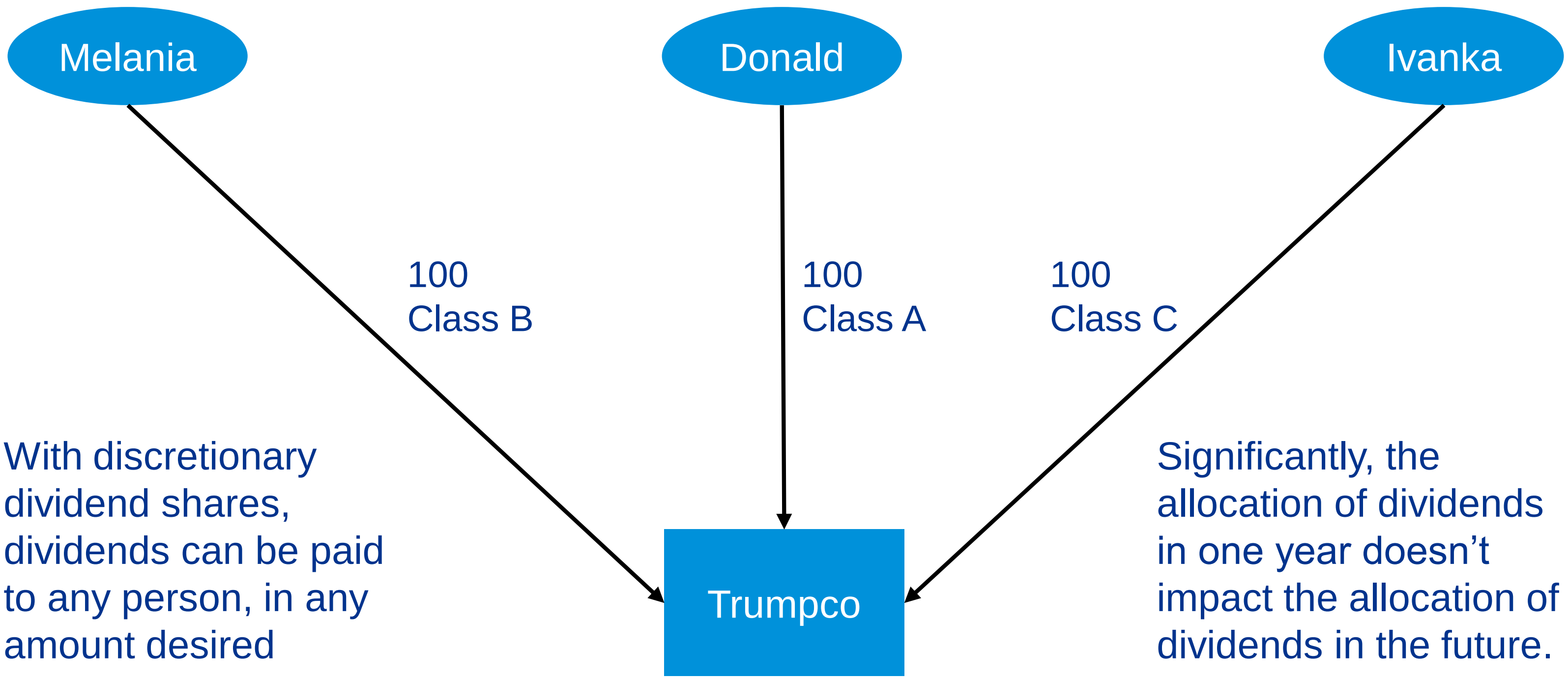
What would you pay for Ivanka's shares?

Note: You would have no assurance of ever receiving a dividend.

What proceeds of disposition should be reported regarding the deemed disposition of these shares on Ivanka's death?

Today's (Tax) Environment

What are the tax planning opportunities associated with discretionary dividend shares?



With discretionary dividend shares, dividends can be paid to any person, in any amount desired

Significantly, the allocation of dividends in one year doesn't impact the allocation of dividends in the future.

Today's (Tax) Environment

What's happened with tax rates in the last 25 years (since 1992)?

- Personal marginal rates were 51% (going to 54% in 1993) vs. 47.7% today
- Low corporate rate (for active business income) was 22.8% vs. 12.5% today
- High corporate rate was 44.8% vs. 26.0% today

Today's (Tax) Environment

Important to understand the impact of "integration" built into our tax system

- In theory, the after-tax income earned directly by an individual should be the same as the after-tax income earned indirectly through a corporation
- Lower corporate taxes should result in higher personal taxes when the after-tax corporate income is paid out as dividends
- No adjustment for earnings previously taxed at higher corporate rates

Today's (Tax) Environment

Important to appreciate the extent of the current differential in tax rates between dividends and capital gains

- Highest marginal tax rate on dividends:
  - Eligible dividends (high corporate rate originally paid on pre-tax income) - 31.30%
  - Ineligible dividends (low corporate rate originally paid on pre-tax income) - 40.95%
- Highest marginal rate on capital gains - 23.85%

Tax Policy Considerations

How is the government reacting to the increasing significance of private companies and the planning opportunities related thereto?

Federal Budget Plan – 2017 – Page 199

Tax Planning Using Private Corporations

The review of federal tax expenditures highlighted a number of issues regarding tax planning strategies using private corporations, which can result in high income individuals gaining unfair tax advantages. A variety of tax reduction strategies are available to these individuals that are not available to other Canadians.

These strategies include:

Today's (Policy) Environment

Issue #1: Choosing to make corporate distributions after realizing capital gains

Federal Budget Plan – 2017 – Page 199

Converting a private corporation's regular income into capital gains, which can reduce income taxes by taking advantage of the lower tax rates on capital gains. Income is normally paid out of a private corporation in the form of salary or dividends to the principals, who are taxed at the recipient's personal income tax rate (subject to a tax credit for dividends reflecting the corporate tax presumed to have been paid). In contrast, <u>only one-half of capital gains are included in income, resulting in a significantly lower tax rate on income that is converted from dividends to capital gains</u>. *(emphasis mine)*

Today's (Policy) Environment

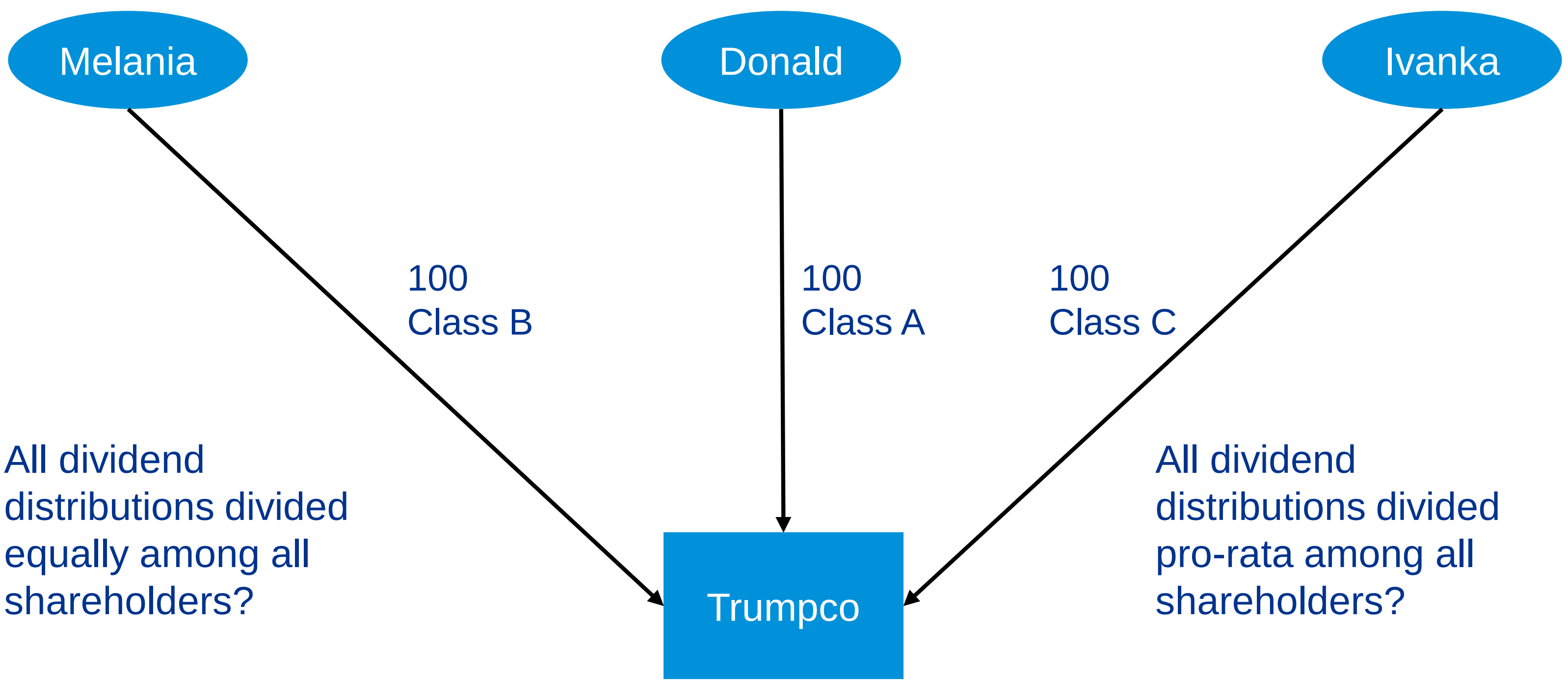
Issue #2: Income sprinkling

Federal Budget Plan – 2017 – Page 199

Sprinkling income using private corporations, which can reduce income taxes by causing income that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized (e.g., via dividends or capital gains) by family members who are subject to lower personal tax rates (or who may not be taxable at all).

Today's (Policy) Environment

How do you put the genie back in the bottle?



Today's (Policy) Environment

Issue #3: Deferral of after-tax business income.

Federal Budget Plan – 2017 – Page 199

Holding a passive investment portfolio inside a private corporation, which may be financially advantageous for owners of private corporations compared to otherwise similar investors. This is mainly due to the fact that corporate income tax rates, which are generally much lower than personal rates, facilitate accumulation of earnings that can be invested in a passive portfolio.

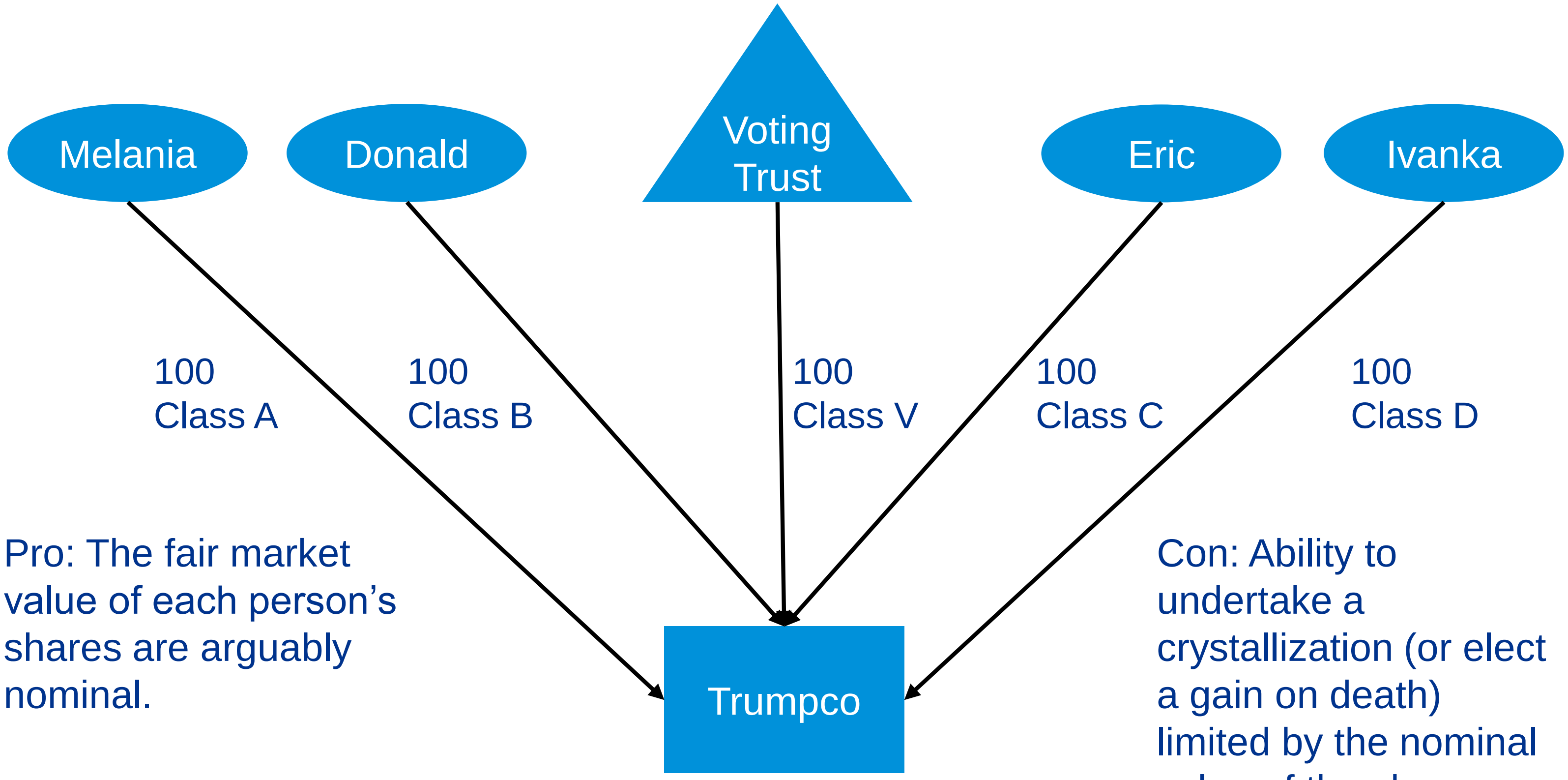
Today's (Policy) Environment

Historically, the tax system has been used to incentivize those in our society who have been willing to take the risk to start businesses and, in the process, provide jobs and other opportunities for those not so inclined.

Do we have too many entrepreneurs?

Voting trusts - Strengthening FMV Argument

Minimizing deemed dispositions on death

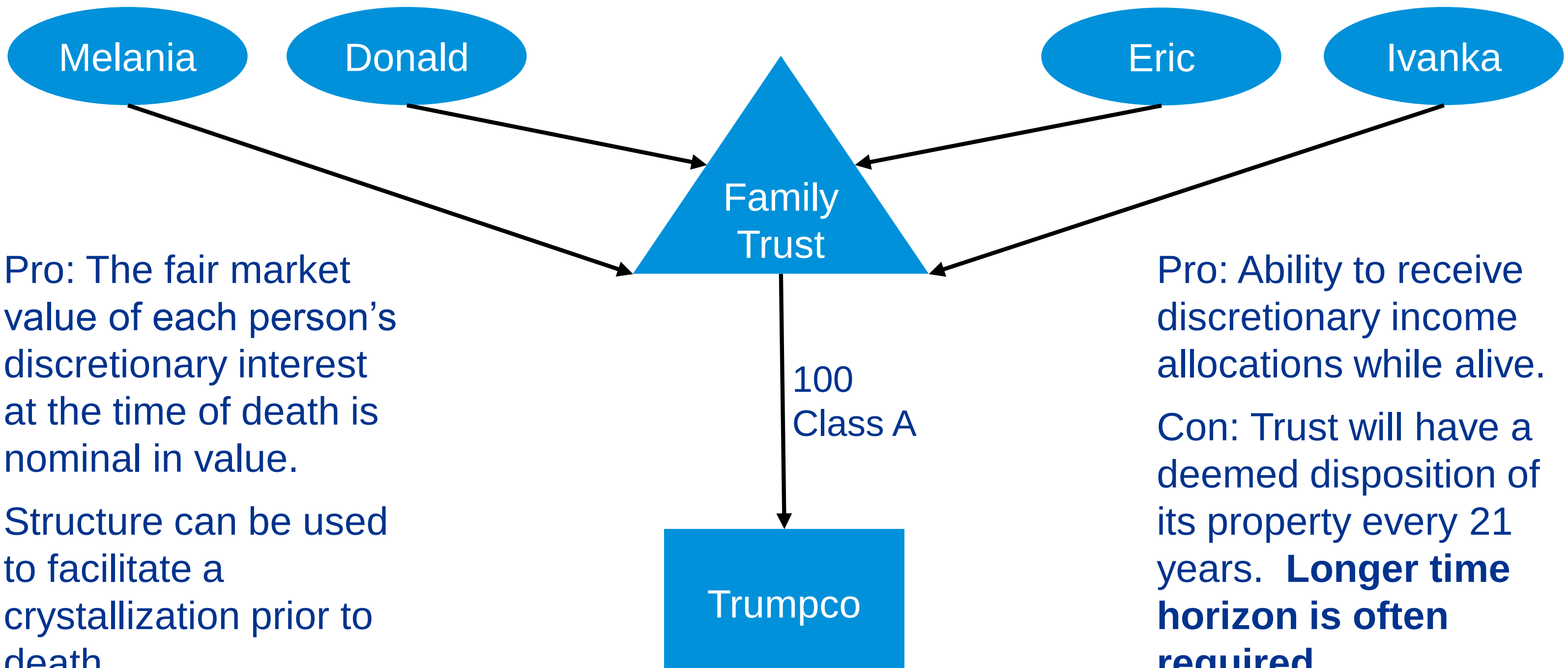


Pro: The fair market value of each person's shares are arguably nominal.

Con: Ability to undertake a crystallization (or elect a gain on death) limited by the nominal value of the shares.

Discretionary trusts - Maximum Flexibility

Minimizing deemed dispositions on death while ensuring access to income while alive



Pro: The fair market value of each person's discretionary interest at the time of death is nominal in value.

Structure can be used to facilitate a crystallization prior to death.

Pro: Ability to receive discretionary income allocations while alive.

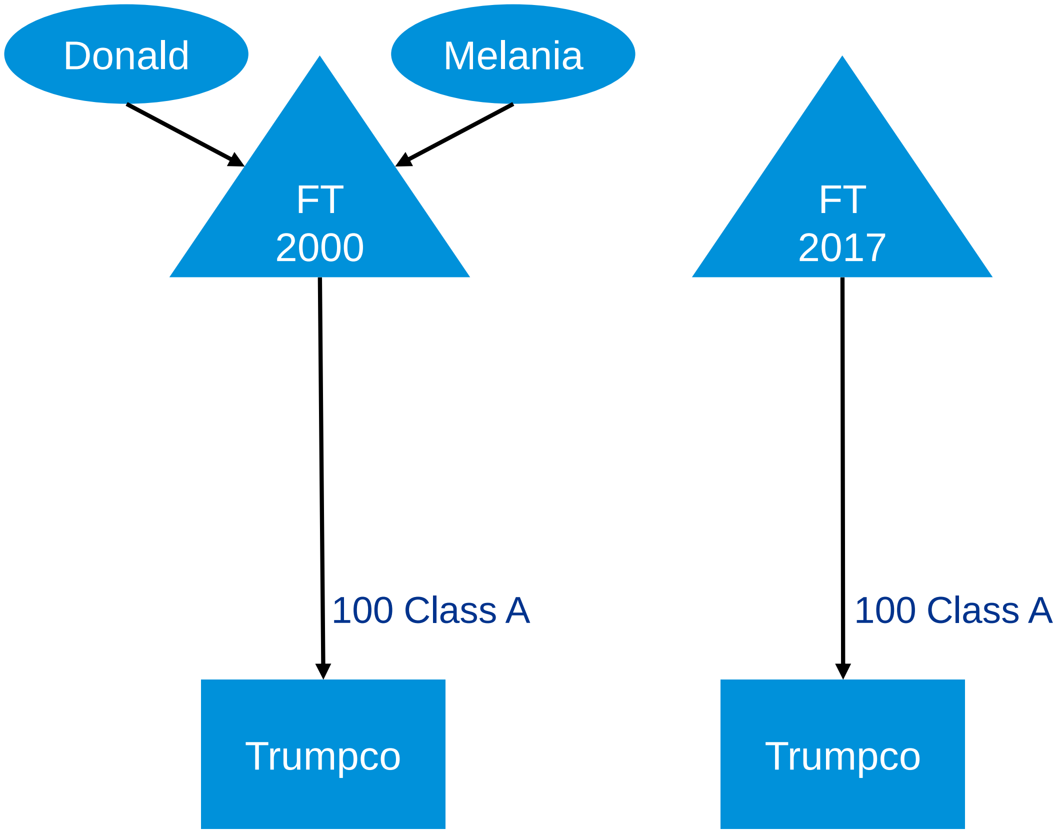
Con: Trust will have a deemed disposition of its property every 21 years. **Longer time horizon is often required.**

Discretionary trusts - 21 Year Considerations

Managing a time horizon beyond 21 years

Q: Can we distribute the shares of Trumpco from FT2000 to a new family trust and take advantage of another 21 year time horizon?

A: We can make the distribution, but FT2017 will effectively end up in the same position as FT2000.

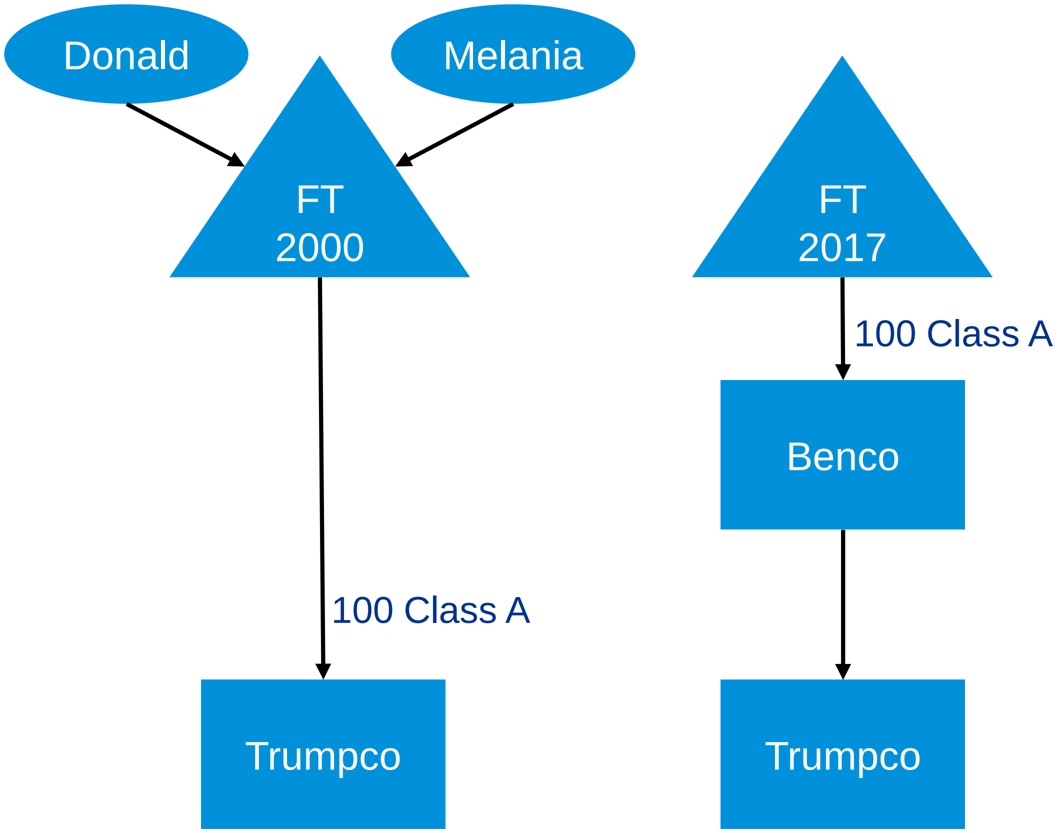


Discretionary trusts – 21 Year Considerations

Managing a time horizon beyond 21 years

Q: Are there any other options to consider?

A: Technically, this can work, but the CRA considers this to be an abuse of the ITA and would likely challenge such a strategy.



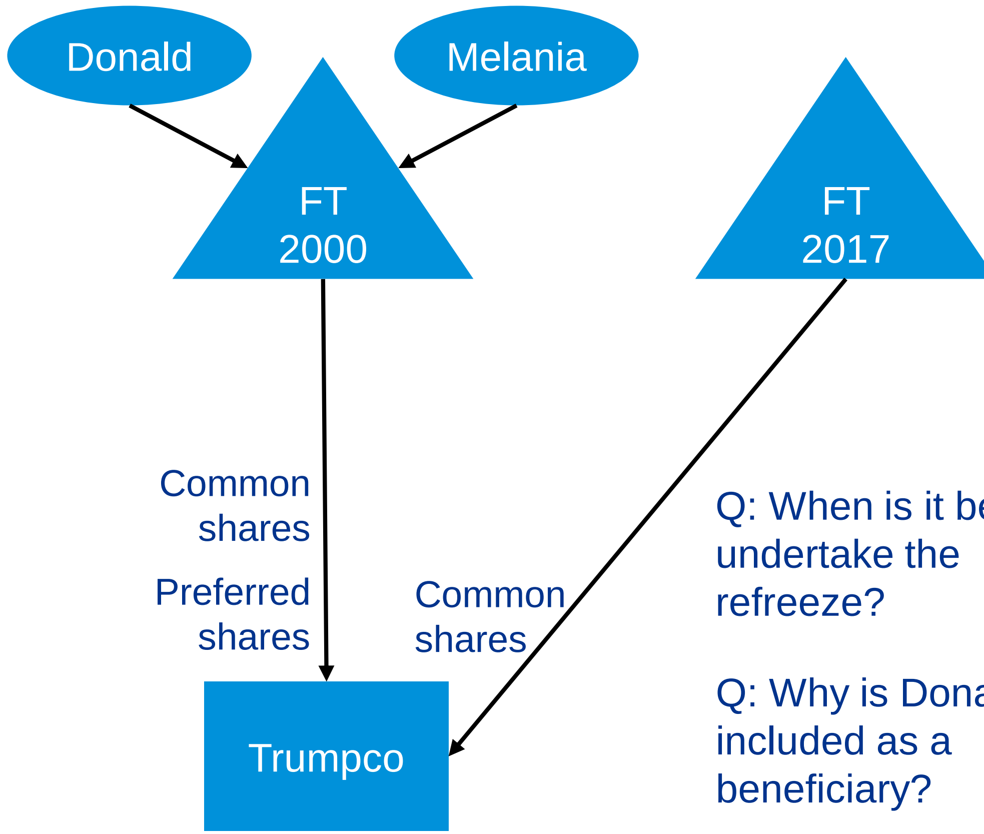
Discretionary trusts – 21 Year Considerations

Managing a time horizon beyond 21 years

Q: Are there any other safer options to consider?

A: A freeze in favor of a new trust is an option that is often chosen to manage the time horizon.

Note: The Preferred shares held by the original trust would most often be redeemed over time (i.e., wasting freeze).



Q: When is it best to undertake the refreeze?

Q: Why is Donald included as a beneficiary?

Alter-ego and Joint-Partner trusts

What are the requirements?

- Inter-vivos trust created by an individual that was at least 65 years of age
- The individual (or the individual's spouse/partner) is entitled to receive all of the income that arises before death of the individual (or spouse/partner, if survivor)
- Prior to death of the individual (or spouse/partner, if survivor), no one may receive other otherwise obtain the use of any of the income or capital of the trust

Alter-ego and Joint-Partner trusts

What are the pros/cons?

- Reduction in probate fees otherwise payable
- Eliminates wills variation concerns
- Ensures confidentiality of ultimate transfers
- Ability to transfer assets to the trust on a tax-deferred basis (unless, for an AET, you elect to have deemed dispositions every 21 years)
- Attribution of income to settlor while alive
- Increased compliance costs (i.e., need to file T3 Return each year)

Alter-ego and Joint-Partner trusts

Implications at death of settlor or survivor?

- Deemed disposition of capital property at the end of the day on which when the settlor (or survivor, as the case may be) dies
- Deemed year end for the trust at the end of the day on which when the settlor (or survivor, as the case may be) dies

Alter-ego and Joint-Partner trusts

Implications at death of settlor or survivor?

- Deemed disposition gains must be taxed in the trust (at the highest marginal rate) as there is no flow-through of such gains permitted
  - Inability to flow-through gains on QSBC shares means that no QSBC exemption is available (must crystallize any QSBC gains in advance)
- Total charitable gifts will include property donated within 90 days of the deemed dispositions

Spousal trusts (Inter-vivos)

What are the requirements?

- Can transfer property to spouse/partner on a tax-deferred basis (or elect to transfer at FMV) at any time – consequently, no age requirement for transfers to inter-vivos spouse trust
- The spouse/partner must be entitled to receive all of the income that arises before death of the spouse/partner
- Prior to death of the spouse/partner, no one may receive other otherwise obtain the use of any of the income or capital of the trust.

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Spousal trusts (Inter-vivos)

What are the pros/cons?

- Reduction in probate fees otherwise payable
- Eliminates wills variation concerns
- Ensures confidentiality of ultimate transfers
- Ability to transfer assets to the trust on a tax-deferred basis
- Attribution of income to settlor while alive
- Increased compliance costs (i.e., need to file T3 Return each year)

Spousal trusts (Inter-vivos)

Implications at death of spouse/partner?

- Deemed disposition of capital property at the end of the day on which the spouse/partner dies
- Deemed year end for the trust at the end of the day on which the spouse/partner dies

Spousal trusts (Inter-vivos)

Implications at death of spouse/partner?

- Deemed disposition gains must be taxed in the trust (at the highest marginal rate) as there is no flow-through of such gains permitted
  - Inability to flow-through gains on QSBC shares means that no QSBC exemption is available (must crystallize any QSBC gains in advance)
- Total charitable gifts will include property donated within 90 days of the deemed dispositions

Graduated Rate Estates ("GRE")

Definition: Estate that arose as a consequence of an individual's death if:

- ❑ Within 36 months of death
- ❑ Estate is a testamentary trust
- ❑ Certain filing requirements are respected (SIN provided, designation made in <u>first</u> return, and only one estate designated as GRE)

Graduated Rate Estates ("GRE")

Points to Consider:

- ❑ Possible to have 4 taxation years with progressive marginal rates (beneficiaries willing to wait for distribution of capital?)
- ❑ Single will – executors sign the T3 Return and make the designation
- ❑ Multiple wills:
  - ❑ Only one estate (and T3 Return)
  - ❑ Wills should refer to each other and provide for information sharing

Graduated Rate Estates ("GRE")

Points to Consider:

- Rollover to spouse or testamentary spouse trust will only apply where the property has vested indefeasibly in the spouse or spouse trust within 36 months of the deceased's death
  - Need to ensure undue delay or preferred share redemptions don't negate the rollover
- Maintenance of GRE status is required to allow 164(6) planning and flexible donation planning

Spousal trusts (Testamentary)

What are the requirements?

- Trust created by will of a taxpayer who died after 1971
- The spouse/partner must be entitled to receive all of the income that arises before death of the spouse/partner
- Prior to death of the spouse/partner, no one may receive other otherwise obtain the use of any of the income or capital of the trust.

Spousal trusts (Testamentary)

What are the pros/cons?

- Ability to transfer assets to the trust on a tax-deferred basis (if property vests indefeasibly within 36 months of deceased)
- Ability to determine ultimate beneficiaries (rather than have spouse determine them)
- Increased compliance costs (i.e., need to file T3 Return each year)

Spousal trusts (Testamentary)

Implications at death of spouse/partner?

- Deemed disposition of capital property at the end of the day on which the spouse/partner dies
- Deemed year end for the trust at the end of the day on which the spouse/partner dies

Spousal trusts (Testamentary)

Implications at death of spouse/partner?

- If:
  - Spouse/Partner is resident in Canada and the trust is a testamentary trust that was created by will of taxpayer who died before 2017; and
  - Joint election is properly filed by trustees of spouse trust and executors of the spouse's GRE,
- Then, deemed gains transferred to deceased (possible progressive marginal rates of tax)

Spousal trusts (Testamentary)

Implications at death of spouse/partner?

- If no election, then deemed disposition gains must be taxed in the trust (at the highest marginal rate) as there is no flow-through of such gains permitted
  - Inability to flow-through gains on QSBC shares means that no QSBC exemption is available (must crystallize any QSBC gains in advance)
- Total charitable gifts will include donations made within 90 days of deemed dispositions

Trusts and Principal Residences

Background Information – NWMM (Oct. 3, 2016)

- Prior to 2017, a “personal trust” that held a property where a person beneficially interested in the trust (or spouse/former spouse or child) ordinarily inhabited the property and made the required designation was entitled to claim the “principal residence exemption”
- After 2016, the designation of a year eligible for the principal residence exemption is going to be more restricted (based on the draft legislation)

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Trusts and Principal Residences

Background Information

- For taxation years after 2016, only certain trusts will be eligible to designate a year as being eligible for the exemption:
  - Life interest trusts (i.e., alter-ego, spousal, joint partner and certain self-benefit trusts)
  - Qualified disability trusts
  - Inter-vivos or testamentary trust for minor children where both parents are deceased

Trusts and Principal Residences

Issues to Consider

- ❑ Draft legislation will hopefully be revised
- ❑ Inter-vivos trust for disabled child (not QDT)
- ❑ Inter-vivos trust or testamentary trust for capable adult children
- ❑ Inter-vivos trust or testamentary trust for minor child where only one parent is deceased
- ❑ Trusts established to own vacation property
- ❑ Transitional rules; rollout option; many other issues not discussed above

Thank you

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