COMMON TAX MISTAKES IN ESTATE PLANNING

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This chapter deals with the most common tax planning mistakes made in an estate planning context. The list is not exhaustive, and the selection of the particular topics is subjective. However, based on the experience of the author, these mistakes are both common and easily prevented.

1. INAPPROPRIATE POST-MORTEM ESTATE PLANNING

There are three main techniques which are used in post-mortem estate planning, to either reduce the tax liability of the deceased or that of the Estate. Each of these is described briefly below, by way of introduction.

A. Capital Loss Carryback

If a capital loss results, on an overall basis, in the first taxation year of the Estate, it may, by election, be carried back against capital gains realized by the deceased on death. In addition, if after application of such capital loss, an overall capital loss results on the deceased taxpayer's return, it may be deducted, to the extent of 50%, against other sources of income.

There are various requirements for using this election, but the most important one is to realize such net capital losses in the first taxation year of the Estate, and not afterwards. Certain planning steps can be taken to create or increase capital losses in the Estate, for example from a redemption of shares.

Mistake 1 – Failure to Realize Losses

Failure to take appropriate steps to utilize a carryback of capital losses of the Estate to the tax return of the deceased is the most common mistake with respect to capital losses.

This mistake occurs for one primary reason, which is the failure to realize losses, as may be appropriate, in the first taxation year of the Estate. However, there are certain fundamental causes which result in this mistake occurring. One is to set the year end of the Estate to be, for example, December 31st. While this may be convenient, if the deceased died in say November, this gives only a short window of opportunity to realize these losses, whether they result from an actual decline in value of assets, or from deliberate tax planning (such as structuring a share redemption). In addition, the losses must actually be realized, and cannot merely be accrued. Accordingly, the capital property must actually be disposed of, in order for a capital loss to result.

B. Step-up Strategy

Where an Estate obtains shares of Canadian corporations, a partnership interest or, in some cases, a trust interest, a transaction can be carried out to step-up the cost base of the underlying assets in the entity. This is most commonly encountered in the case of a corporation, but similar rules do apply to partnerships and trusts. This step-up, or "bump" as it is commonly referred to, must be done through some form of corporate reorganization or dissolution, and a description of the techniques is beyond the scope of this material. The step-up applies to non-depreciable capital property, which may include such things as shares of other corporations (including portfolio shares), land which is capital property, or a partnership interest. Generally speaking, the step-up is limited to the fair market value of the capital property in the underlying entity at the date of death, but may also be subject to certain other limitations.

Mistake 2 – Unidentified Benefit

The most common mistake with the step-up is failure to take advantage of it, generally through lack of knowledge of the rules giving rise to this opportunity. Unlike the capital loss election above, there is no time limit for the step-up, but it must actually be claimed through execution of legal steps, and a designation must be made.

C. Pipeline Transaction

The pipeline transaction is most commonly applied to shares of a Canadian private corporation left to the Estate on death. Assuming that the Estate is not a spousal trust, or, if it is, that an election is made for the transaction to occur at fair market value, then the Estate will obtain an adjusted cost base in the shares equal to that fair market value. The pipeline transaction then proceeds through a transfer of these shares to a Canadian holding company, in exchange for a promissory note for the amount of the adjusted cost base. A dividend is then paid by the underlying corporation to the newly established holding company, which will be tax-free, followed by repayment of the note. In this way, the Estate is able to obtain the retained earnings of the corporation free of any tax at the shareholder level.

Mistake 3 – Payment of Dividends

Taking out funds by a dividend to the Estate, without considering how to withdraw funds tax-free using the pipeline method.

Summary

Post-Mortem Estate Planning is complicated and very fact specific. The optimum planning steps in one case may be very different to what would be done for the next. Each of the three techniques above have circumstances where they will be highly appropriate, and circumstances where they may be disadvantageous. Also, the techniques can be used in combination, leading potentially to a much more complex sequence, but potentially a more beneficial result.

Mistake 4 – Not Considering All Options

Failure to consider all of the techniques available in post-mortem estate planning, and apply them correctly to the circumstances. Because these are so fact specific, the only real way to do this is to work through the various alternatives with real numbers in an actual situation.

2. INAPPROPRIATE DONATION STRATEGIES

Introduction

Donations made by an individual give rise to a tax credit, at generally speaking, the top personal tax rate. The amount of donation which may be applied is limited to 75% of net income, and if the donation cannot be used in the current year, it can be carried forward for up to 5 years.

Special rules apply in the year of death where the donation amount can be applied up to 100% of net income. In addition, if a donation cannot be used in the year of death, it can be carried back and applied in the previous year.

Donations of publicly-listed shares derive an additional advantage in that no amount of the capital gain resulting from the disposition is included in income. This makes the donation worth substantially more, particularly if the shares which are donated have a large accrued gain.

Donations made by Will, which are disbursed by the Estate, are claimable on the terminal tax return of the deceased and, if need be, the previous year, as if they were made by the deceased before death.

At death, donations which cannot be used in the year of death or the previous year do not carry forward, and disappear. However, by administrative practice, the Canada Revenue Agency ("CRA") allows donations to be claimed by either spouse, such that if the deceased cannot use a balance of donations, that balance may be applied to the spouse's return, and then carried forward for 5 years.

There are numerous mistakes made with respect to both donation strategies and the claiming of donations, particularly in the year of death.

Mistake 1 – Unused Donations

It is quite common to see large donations made by Will, and meanwhile the deceased did not make significant donations during his or her lifetime. This can result in donations being unused, where if donations had been made on a more gradual basis, a greater tax benefit would have resulted. Where the deceased has unused donations, steps should be taken to increase the income of the deceased through whatever means possible. See further comments under Spousal Rollover.

Mistake 2 – Not Donating Publicly Traded Shares

Because of the benefit of donating publicly-listed stocks, it is preferable to do this rather than donate cash. Often this is not done, resulting in a lost opportunity. In addition, the stocks to donate are those with the highest gain to fair market value ratio. This maximizes the benefit of the donation strategy.

Mistake 3 – Poor Will Drafting

Certain stipulations are required in order for a donation which is made by Will to be recognized as that of the deceased. Generally speaking, this is beneficial, and normally the intended result is that the donations disbursed by the Estate will be applied by the deceased. However, care must be taken to ensure that the Will is properly drafted so that this result does in fact occur. If the amount to be donated can be determined by the Executors, and is not stipulated in some way (possibly by a formula such as a percentage of the residue of the Estate) in the Will, then the donation may be applied only by the Estate.

Mistake 4 – No Spousal Transfer

Failing to transfer an unused donation of the deceased to the tax return of a spouse, as allowed under CRA administrative policy.

3. DESIGN OF WILLS

Introduction

The tax considerations involved in designing a Will, particularly for a significant Estate are important and have far reaching consequences. Firstly, if substantial donations are to be made, normally it is appropriate for these to be structured as claimable by the deceased. See discussion above.

Secondly, if there is a surviving spouse, then a tax-free rollover is available for such assets as are left to the spouse or a spousal trust.

Finally, the creation of multiple testamentary trusts can be beneficial, in that a significant benefit can result by arranging for income in the Estate to be taxed in these various testamentary trusts, each of which obtains the graduated tax brackets applicable to individuals.

From a tax perspective the most common mistake with respect to the design of Wills revolves around these three matters. The first has been discussed under the heading Donations.

Mistake 1 – Non-Qualifying Spousal Trusts

Failure to make sure that a trust created under the Will is in fact a spousal trust. There are specific rules concerning a spousal trust, which are quite restrictive. In addition, in certain circumstances, if a trust does not qualify as a spousal trust, certain steps can be taken to make it qualify. One common mistake is to provide that a trust for the spouse shall be exclusively for the spouse for his or her lifetime or until such time as there is a remarriage. This disqualifies the trust from being a spousal trust. If the idea is to preserve the assets for other beneficiaries, say children, in the event of remarriage, then restrictions can be placed on capital encroachment, while still ensuring that the trust qualifies as a spousal trust.

Mistake 2 – Use of Testamentary Trusts Not Optimized

Failure to create multiple testamentary trusts which would benefit from graduated tax rates, or failure to have income taxed in these trusts, by having the income distributed to beneficiaries who are taxed at a higher tax rate. A supplementary mistake is the failure to allocate income to beneficiaries in a way which is most beneficial, such as interest income to a beneficiary with little or no income, while tax favoured components of income, such as Canadian dividends or capital gains, are allocated to beneficiaries who have more substantial income.

Another mistake is to fail to make an election to have income taxed in the testamentary trust where the terms of the Will provide that all income is to be paid out. By election, the income can still be subject to tax in the testamentary trust, even though the Will states that the income is to be disbursed to beneficiaries. This mistake is particularly common with a spousal trust, which, by its terms, will require that all income be paid out.

4. ESTATE FREEZE

An estate freeze can be beneficial in limiting the tax on death paid by the "freezor", while passing on future growth to the next generation, where the capital gain will be postponed for their life expectancy or until there is a disposition. An estate freeze is most effective where the freeze is done at a relatively low value, and the future appreciation is significant. However, if the assets in question are investments assets in a holding company, the estate freeze may have no practical benefit because of the refundable dividend tax on hand system.

There are numerous mistakes in carrying out an estate freeze, both from a tax and a family financial perspective. One mistake is to freeze at too low a value, such that the freezor has no ability to participate in future growth, and later in life finds that he or she is short on funds which was unintended.

An estate freeze can also trigger an income attribution rule which imputes income to the freezor based on a formula tied to the prescribed rate of interest, if certain people are participants in the estate freeze (this includes a spouse of the freezor or persons under the age of 18 who are direct shareholders or indirect shareholders through a trust). This imputation rule can be particularly punitive where the amount of the frozen value is large and/or the prescribed rate is high. Currently the 1% prescribed rate makes this rule far less onerous then it would be if the prescribed rate was significantly higher. Note that the prescribed rate has been as high as 16% in the past.

<u>Mistake 1 – Failure to Monitor</u>

Leaving the estate freeze on automatic pilot without monitoring.

There are two important ways in which an Estate freeze should be monitored. The first is that any payments going out to the freezor by which of dividends should be evaluated in terms of share redemptions instead. This would reduce the value of the frozen shares, reducing the potential capital gains tax which could arise at death. Since the freezor would pay personal tax on any dividend received, there is no incremental tax to paying out the dividend in the form of a share redemption, which creates a deemed dividend for tax purposes.

The second important aspect to monitoring the estate freeze is to periodically review values, particularly if there is a decline in values. The estate freeze can be redone, to refreeze at a lower value, potentially making the plan more effective.

5. CAPITAL GAINS EXEMPTION

Introduction

The capital gains exemption is an exemption of up to $750,000 of capital gains, on the sale of shares of a small business corporation, or certain farming or fishing properties. There are numerous restrictions on claiming the exemption, but the most significant of them are realizing a gain from the sale of shares at the personal level (the exemption cannot be claimed for a gain realized within a corporation), and making sure that the corporation qualifies as a small business corporation. This requires that, at the time of sale, at least 90% of the assets of the corporation be used in an active business carried on primarily in Canada.

Mistake 1 – Inappropriate Corporate Structure

It is common to find a corporate structure which prevents the capital gains exemption from being utilized. For example, two operating companies held by a holding company can make the exemption unavailable, if one company is to be sold without the other. This is because the gain would be realized in the holding company, not at the personal level.

Mistake 2 – Excess Cash

Successful companies accumulate cash, unless the cash is withdrawn in some manner, say by way of dividends or bonuses. The accumulation of excess cash, or investment assets, can make the exemption unavailable, unless steps are taken to remove it. These steps usually result in a tax liability. Also, if the cash or investment assets exceed 50% of the total value of the assets, then a two-year holding period rule applies, so that these assets must first be removed, and then the shareholder must wait 2 years before the exemption is available.

Mistake 3 – Failure to Multiply the Exemption

Because the exemption is $750,000 per individual, it is beneficial to involve other family members as shareholders, to multiply the use of the exemption. It is not possible to introduce other shareholders at the last-minute, in order to multiply the exemption, because the appreciation in value must occur in their hands.

Mistake 4 – Crystallization of the Exemption for Minor Children

There is a popular type of transaction called a crystallization, where a gain is deliberately created to "lock in the capital gains exemption". A gain is deliberately triggered, and claimed as exempt under the capital gains exemption to step-up the cost of the shares. As a result of changes to the so-called Kiddie Tax rules, a crystallization which triggers a capital gain in the hands of persons under the age of 18, will result in the gain being deemed to be a dividend (an ineligible dividend to be specific) which will be taxable in the hands of the minor children at the top tax rate. This rule does not apply on a disposition of the shares to an unrelated person.

Mistake 5 – Extracting the Gain Created by the Capital Gains Exemption

The adjusted cost base created from the claiming of the capital gains exemption by a related person cannot be extracted on a tax-free basis using a technique such as the pipeline method. See above. The promissory note which is taken back is deemed to be a dividend, which is designed to make sure that corporate funds cannot be extracted in a related party situation through the claiming of the capital gains exemption, without payment of tax.

HOW TO AVOID COSTLY MISTAKES

Here are some tips on how to avoid costly mistakes of the nature outlined above.

1. Make sure all relevant facts are known with accuracy and appropriately considered.
2. Put advice in writing and make sure the client reviews the advice with appropriate due care and attention.
3. Make sure that the advisors are competent and experienced in the areas required.
4. Do not be reluctant to retain a specialist advisor to provide advice on selected aspects of an estate plan and related tax matters.
5. Have an engagement letter on file.
6. Monitor the plan for changes in law and changes in circumstance, and never leave an estate plan on "automatic pilot".
7. Work with a team approach, because no one professional or profession can cover all aspects required in a well designed and sophisticated estate plan.
8. Don't be shy to say I don't know. Professionals who try to be all things to all people on all occasions will ultimately realize the shortcomings of this approach when things go badly wrong.

9. Do not over promise and under deliver. Estate planning from a tax perspective is designed to minimize and postpone tax, but it has limitations. Clients are looking for a good overall result, but not something which is overly aggressive and too good to be true.
10. Do not overlook international issues, which have not been discussed in the material above, but which may be highly relevant depending on the circumstances.
11. Learn the hallmarks of potentially difficult clients and avoid them. Unlike the practice of medicine where every patient deserves an appropriate level of care, not every client seeking tax planning and estate planning advice will be a suitable client for a particular professional. Over the years, a number of hallmarks have emerged of problematic clients, and the comments here serve, very generally, as possible guidelines. So be wary of clients who are overly and excessively demanding, especially if their circumstances do not warrant it. Some things to be wary of:
    - Family situations which could easily erupt in litigation or may be already there, unless you are prepared to work within this environment;
    - Instructions which overly favour certain family members at the expense of others or that seek to defeat or defraud the interests of other family members;
    - Clients who are excessively fee conscious and will not agree to an appropriate level of professional fees;
    - Clients who are suing or have sued their professional advisors in the past (although this point must be tempered by the fact that there may have been good reasons);
    - Clients who frequently change professional advisors;
    - Clients who limit the scope of an engagement unduly making the assignment potentially dangerous; and
    - Lastly be careful of clients who have a limited grasp of the concepts involved and repeatedly ask an inordinate number of questions. (These clients take up disproportionately large amounts of professional time, often being unwilling to pay for it.)

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