



Client Information Summary

Estate Maximization

Estate maximization is just what the name implies, the process of maximizing the estate that will be passed on to your heirs. You should first determine if maximizing your estate is important to you. Or, perhaps you are more like one client who said, "I want to spend my last dollar on the day that I die". A feat, by the way, that is very tough to accomplish!

However, if estate maximization is important to you, the next step is to determine the amount of capital that it will take to maintain your chosen lifestyle during your lifetime. Some people who are retired have more wealth than they require. Your financial advisor has probably performed this calculation for you (if not, he/she can certainly do so). If you fit into this category and are concerned about the net value of your estate (after probate fees, estate administration costs, and taxes), then you will probably want to work with your advisor to develop an estate maximization strategy.

There are two general tactics that are commonly used to maximize estates; the use of **insurance** and the use of **trusts**. One or both tactics may be suitable for you.

As a general guideline, insurance is best in situations when invested assets are less than one million dollars. For larger estates, both tactics might be considered.

THE USE OF INSURANCE

This estate maximization tactic involves the use of joint second-to-die life insurance. To determine the ideal coverage amount, a Second Death Estate Analysis is performed. The analysis takes into consideration probate fees, final expenses, legal fees, income tax, as well as existing permanent insurance. Through the analysis, we can estimate the amount of protection required to preserve 100% of your net worth for your heirs.

Once a coverage amount is determined, then the next step would be to ascertain if insurance would be cost effective.

Is it better to pay an insurance premium or leave the money in your portfolio?

That is, would it be better to use some of the income from your portfolio to pay life insurance premiums to offset anticipated estate shrinkage at time of death - or would it make more sense to just let the money compound in your portfolio. In order to do this component of the analysis, we need to make some assumptions about probable life expectancy, and then calculate the rate of return required on your portfolio to match the insurance value at death. If the return on your investment portfolio required to equal the death benefit of the insurance is excessive, then insurance is probably the most cost-effective option. If the return required is reasonable or well within reach, it may be best to leave the portfolio as it is and allow it to grow. Generally, the shorter the time horizon (life expectancy), the more sense an insurance strategy makes.

For example, Ted and Mary Prudent were advised that should they both die tomorrow, their \$1.5 million dollar estate would immediately shrink to \$900,000, primarily as a result of taxation. Yet, based on their projected level of spending, and on a conservative return on their investment portfolio, they will always have a considerable income surplus. In other words, they will never spend all of their capital. As a result, they decide to explore maximizing their estate by using a portion of the capital in their portfolio to generate an income to pay the premiums on a joint second to die policy for the \$600,000 difference. A portion of the income from their existing portfolio will pay the premium until the second death. At that time, their estate gets \$600,000 of tax free dollars to cover the anticipated shrinkage. The question is - does it make sense financially?

Their advisor explained that if they are in good health for their age, the insurance company would require an annual premium of \$3,800 (they are both age 55 and non-smokers). We know that their estate will get \$600,000 if they die. But, would their estate have been better off just re-investing the \$3,800 each year back into a balanced portfolio? Their advisor calculated that if they both die at life expectancy (an actuarial calculation), the life insurance policy actually represented a return of 7.77% net after tax. If they died sooner, the return is of course higher. If they died later, the return is lower. However, they reasoned that based on life expectancy, the joint second to die coverage seemed to make sense. Nearly 8% net after tax is a very good guaranteed return. In fact, in their tax bracket they would have to earn over 16% on their portfolio to beat it!

But, knowing that there is no free lunch, they wondered how is it possible that a life policy can pay such a good return (on death). Good question! The answer lies in the special tax status that life insurance companies enjoy - and the fact that the death benefits are tax-free! It's something like the special tax sheltered status that an RRSP enjoys, but unlike an RRSP, it always stays tax sheltered, whereas you have to pay tax when you take money out of your RRSP. On the other hand, all insurance premiums in Ontario are subject to a 2% premium tax (the example above takes that into account). The insurance option should be considered a long term commitment too.

THE USE OF TRUSTS

A second, more complicated estate maximization tactic involves the use of trusts, which we will describe in some detail.

What is a trust?

Trusts have been around for hundreds of years but they all entrust a *trustee* with assets and property held on behalf of a *beneficiary*. They can be set-up while alive, in which case they are called an *inter vivos trust* or after death, in which case they are called a *testamentary trust*. In a formal trust, the terms of the trust are defined in the trust agreement or will and the person who is providing the property to the trust is called the *settlor*. The trustee is legally obligated to follow the terms of the original trust documents, unless the terms have been varied by a court (this happens all too often in our opinion). Beneficiaries of trusts may benefit from the income, or the

capital from the trust depending on the terms, or they may have to wait till a future event to benefit (typically reaching a certain age in the case of a minor).

For tax purposes, a trust is treated like a person. A trust files its own tax returns and may be subject to tax (a trust that distributes all its income to beneficiaries is not taxable which is why most mutual funds are set-up as trusts).

How can a trust be used?

Trusts have traditionally been used to deal with specific problems. Sometimes trusts are used to solve family problems, such as succession issues. Sometimes, trusts can be used to solve tax problems. The following list is not by any means comprehensive, but it does give a snapshot of some common uses.

Spousal Trust: This trust is set up using a rollover provision under the Income Tax Act, to transfer assets from one spouse to another, without triggering income tax on capital gains. It does not work to lower the tax rate on income from the asset however, as any income is subject to attribution back to the donor. When the spouse with ownership of the asset is the more likely to die first, this serves to put the asset in the other spouses name now. This would be used to avoid the asset going through probate.

Family Trust: This trust, used for the benefit of the family, does not permit a rollover of assets to children without triggering tax on capital gains. However, used properly as part of an estate freeze, it can permit the transfer of future growth and income to family members. This can allow for income splitting, estate division, and possibly the multiplication of the small business capital gains exemption.

Note that income from an inter-vivos trust (one that is set up by a live person, not one set up by a will upon the person's death) is taxed at the top marginal rate, unless the income is paid to the beneficiary and a T3 is issued, which then shifts the tax liability to the beneficiary. This can be beneficial in the case of minor children because as long as the income is less than their personal exemption, there would be no tax on it. But if the trust is an inter vivos trust, the attribution rules would come into play, whereby income from gifted property is attributed back to the parent. Capital gains are not subject to the attribution rules.

Testamentary Trust: This is a trust set up in a will to carry out your wishes after death. While not deferring capital gains tax, unless a spousal rollover is possible, it can allow for the custody of assets left to small children, for the central control of family businesses, and so on. Both spousal and family trusts can be testamentary trusts. One of the best uses of a testamentary trust is in income splitting. Let's look at an example. John Welltodo is a widower with \$2,000,000 in invested assets. He has 2 grown children and numerous grandchildren. Both of his children are well established and successful, so successful in fact that they are all in the top tax bracket (46.4%). In his will, John has set-up 2 separate trusts, one for each child. The terms of the trust are that each child can encroach (use) the capital if they wish but they can choose to have the capital remain untouched in the trust. The income for each trust is taxable by the trust if it is not distributed. Each trust would pay tax based on the graduated rates the same as an individual tax payer but without the personal exemption. If we assume that each trust earns 5%, then if John dies, each trust would have \$1,000,000 of capital and an income of \$50,000. If John had simply left the capital to each child, they would each pay \$50,000 times 5% times 46.4% or \$23,000. Having the trust pay the tax and thus creating a new taxpayer, the trust would pay only \$9,500, a savings of \$13,500 per year!

Trusts are a useful tool for the person with significant assets and the need to do some estate and tax planning. They have traditionally been a means for providing extra flexibility in the handling of assets, and can also offer some unique advantages for saving taxes.

One of the key aspects of trusts is that, except for any required tax forms, there are no filing requirements for them. They are private arrangements. They are not registered in any government data bank as corporations are. They are not filed in court as are wills, and they are not a matter of public record.

Trusts can also provide enormous flexibility. Assets can be held in separate title from the original owner, and from the ultimate beneficiary. Terms of management of the assets can be laid out, and some degree of ongoing involvement can be included, subject to certain tax rules.

Here are some of the specific uses that people make of trusts to maximize their estates.

- ⇒ Trusts are used to defer the payment of capital gains.
- ⇒ Trusts are used to divide income and assets to take advantage of the lower tax rates in the progressive tax system.
- ⇒ Trusts are used to protect assets from creditors.
- ⇒ Trusts are used to avoid probate tax.
- ⇒ Trusts are used to keep control of family assets or businesses within the family and even to one designated person (like the head of the family), while spreading beneficial ownership around the family, resulting in significant tax savings.

Not every trust can achieve all of these goals, and it is not always cost effective to use a trust. However, when they are appropriate, trusts can be powerful tools to achieve what can be done no other way.

For example, a grandparent might establish a family trust for the benefit of children and grandchildren. Structured properly, capital gains on the investments which the grandparents made via the trust could be taxed in the hands of the children or grandchildren. This can result in savings of thousands of dollars in taxes on income, which would have otherwise been taxed at the grandparents' high rates.

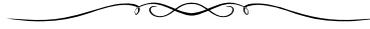
Canada Revenue Agency is well aware of the power inherent in the use of trusts, and has over the years moved to restrict their tax attractiveness. There are numerous complex rules, and some advantages have been taken away.

CAUTIONS

Trusts can be very beneficial, when used in the correct circumstances. However, it is imperative that professional advice be obtained, for there are numerous traps for the unwary. The tax rules for the use of trusts have been tightened considerably. The use of a trust does involve some loss in control. The trust becomes the legal owner of the asset and the trustee(s) control these assets. There are costs associated with setting up and administering the trust and filing tax returns. Tax laws change, and families grow and break up. Flexibility is possible with trusts, but that potential must be built into them from the beginning.

CONCLUSION

Regardless of the tactics used, a well-structured and documented estate maximization strategy can enhance your peace of mind as well as the value of your estate for your heirs.



Page Client Information Summary

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