CLU ADVANCED LEARNING SERIES

CASE STUDY: BLENDED FAMILIES AND BUSINESS SUCCESSION

Advocis

Case Study: Blended Families and Business Succession

Learning Objective

- Identify relevant estate planning objectives and considerations important to blended families and business owners.
- Align and explain retirement and estate planning strategies that address planning objectives for blended families when business ownership and succession is involved.

Case Study: Blended Families and Business Succession

Question 1

Consider the problems that Steve's existing estate plan might cause in the event of his death in 2035. Given his current plans and obligations, outline four initiatives Steve should take to ensure that his family's welfare is addressed both today and after he dies. Consider Wills, Powers of Attorney, and other documents and strategies he could pursue to meet their needs.

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Question 1 Solution

Will

- Divorce from Angela may have cut her out of Steve's old will
- If Angela was sole beneficiary of the old will – Steve is now intestate
- If children were residual beneficiaries of the old will – no protection for Beverly or Chip
- Steve needs to execute a new will

Powers of Attorney

- No longer appropriate to have his ex as his representative under PAs
- Needs to execute new PA for property and personal care
- Early in their relationship, it may be too soon to name Beverly as his representative
- Consider suitable third party to act as power of attorney

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Question 1 Solution, continued…

Joint Property

- Sever joint ownership with ex-spouse of existing vacation property
- Possibly, sell Steve's half to Angela or a third-party?
- Alternatively, both Steve & Angela to sell the property and split proceeds

Existing insurance

- $250,000 policy – change beneficiary from Angela
- New beneficiary = estate? add liquidity?

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Question 1 Solution, continued…

Consider new insurance

- Consider more life insurance to cover obligations

  Steven: Angela & Beverly (ex-spouse/spouse); Roberta & Michael (children); Chip (Beverley's son)

  Beverley: Chip (son)

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Question 1 Solution, continued…

Cohabitation Agreement

- With Beverly
- Protect what he brings into the relationship
- Not an issue until they are considered a common-law couple under provincial legislation
- Rules will differ by province
- Determine rights to property, income, access to Chip

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Question 2

Identify four techniques that Steve and/or Beverly might employ to reduce probate fees in the event of either of their deaths in the near or distant future. Explain whether you would or would not recommend each technique, and why or why not. Assumes we are in 2035.

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Question 2 Solution

Use of Direct Beneficiary on Life Insurance

- Steve's $250,000 term life policy
- Change beneficiary to Beverly or children
- Not practical while children are minors/young

Use of Direct Beneficiary on RRSP

- Rollover to Beverly allows for tax-deferred transfer
- Possible rollover to Chip, if qualifies as disabled and financially dependent (a longer term consideration)
- Naming other children would save probate but not taxes (need to consider the financial implications of assets going direct through beneficiary designation but tax consequences going to estate)

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Question 2 Solution, continued…

Use of Direct Beneficiary on RRSP

- Rollover to Beverly allows for tax-deferred transfer
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Use of Joint Tenancy with Right of Survivorship

- Vacation property (need to consider financial implications to other beneficiaries)

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Question 2 Solution, continued...

Use of Multiple Wills

- Works in some limited provincial jurisdictions
- Shares of Ruff
- Separate will – unprobated
- Would depend on beneficiary(ies)

Use of a Trust

- Alter ego/joint partner trust may be a consideration in later years, but based on facts it is far too soon to consider trust now – too young

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Question 3

Evaluate Charlie's plan for turning over the business to his son and daughter in equal shares and suggest alternate solutions to his plan. Also consider the use of an estate freeze and be very specific about the steps involved, the dollar amounts and the income tax implications of your alternate plan. Discuss how life insurance could play a role in addressing the financial aspects of this transfer of the business interest.

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Question 3 Solution

Conflicts regarding an "equal distribution" of assets

- Total estate is worth $2,350,000 (shares, house & rrsp)
- Need to make an income tax and last expenses assumption for Charlie. Assuming he purified to claim capital gains exemption, taxes on preferred shares could be in the range of $250,000, taxes on RRSP could be in range of $100,000, and last expenses could be in the range of $20,000 for a total of $370,000. This leaves the estate with available assets of about $1,980,000
- Ruff preferred shares are valued at $1,800,000 (leaving only $180,000 of cash assets)
- Financially equal would mean $990,000 each for Steve and Frieda
- As per the case facts, the siblings would each get $90,000 of cash and $900,000 of preferred shares, with Frieda's preferred shares held in a testamentary trust
- This could create conflict: Frieda wants income/Steve wants to grow the company

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Question 3 Solution, continued…

There is a conversation to be had as to what is equal versus what fair in this situation.

- Steve will likely value being the sole shareholder of Ruff as it would give him control and minimize conflict with his sibling
- Would need $1,620,000 of insurance on Charlie’s life to increase Frieda’s share up to $1,800,000 (This assumes that Steve’s inheritance is the $1,800,000 of preferred shares)
- The idea of $1,620,000 of insurance to equalize may well be unrealistic but could be a good start for the conversation of fair versus equal

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Question 3 Solution, continued…

If they wanted to purify the company for the LCGE, based on the 2021 balance sheet

- At present passive assets ($250,000 GICs) = 13.8% of the value of the company's assets
- Exceeds the 90% test to be met for shares to qualify for LCGE
- In order to purify, could:
  - Withdraw at least $70,000 of GICs to reduce passive assets to 10%
  - Redirect at least $70,000 of the GICs in active business assets
  - Use $70,000 of the GICs to reduce current corporate debt

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Question 3 Solution, continued…

The role for an estate freeze

- Designed to pass the future growth of appreciating assets to a target group (in this case Steve) and freeze value of the current shareholder's (Charlie) value held in company shares. Can be designed to provide Charlie with retirement income.
- Steps

1. Steve incorporates a new corporation (Newco), subscribing for the common shares
2. Charlie exchanges his Ruff common shares for preferred shares of Newco
3. Charlie and Newco jointly elect a transfer price of $912,218 (derived as Charlie's $20,000 ACB of Ruff common shares plus his available 2021 capital gains exemption of $892,218)
4. Charlie's ACB of his Newco preferred shares is 912,218
5. Charlie's fair market value of the Newco preferred shares is $1,800,000 (redemption/retraction value)
6. To achieve Charlie's retirement planning, the Newco preferred shares could be dividend-bearing
7. The accrued capital gain on Charlie's Newco preferred shares is $887,782, and will be triggered on Charlie's death. ($1,800,000 – $912,218 = $887,782)

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Question 4

What steps might Steve and/or Beverly consider to reduce taxes at or after Steve's death, in 2035 or later, and calculate the specific tax implications of each technique (for example, how much tax would be payable, when and by whom) relative to each asset.

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Question 4 Solution

Based on case facts:

- Ruff is valued at $3,500,000, therefore Newco must have a similar value because it owns all of the common shares of Ruff
- Steven and Frieda’s trust owns $1,800,000 of Newco preferred shares
- This leads to the conclusion that the common shares of Newco are valued at $1,700,000
- The ACB of Steve’s common shares of Newco is likely nominal

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Question 4 Solution, continued…

Steve's pre-mature death:

- Steve's accrued gain on the Newco common shares is $1,700,000
- If no tax-deferred rollover at death, Steve's capital gain on the Newco common shares is $1,700,000, resulting in a taxable gain of $850,000, and a tax bill of about $425,000 on Steve's terminal return ($850,000 x 50% marginal tax rate)
- The tax consequences outlined in the bullet above could be reduced if the shares qualify for the capital gains exemption. The impact of this change could result in a revised tax bill of $201,946, derived as follows:
  - $1,700,000 - $892,218 (2021 cge) = $807,782 net capital gain
  - $807,782 x 50% -= $403,891 taxable capital gain
  - $403,891 x 50% marginal tax rate = $201,946

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Question 4 Solution, continued…

Spousal rollover consideration:

- If shares are rolled to Beverly at Steve's death, the executor could elect out of the spousal rollover on some of the shares in order to utilize Steve's available capital gains exemption.
  - While we do not have the specific number of shares held by Steve, this strategy would involve electing out of the spousal rollover on a sufficient number of shares to create a capital gain of $892,218, with spousal rollover applied to the remainder of the shares
  - Beverley's fair market value of the shares is $1,700,000 and her ACB on the shares is $892,218
  - Later, assuming the shares continue to qualify for the lifetime capital gains exemption, Beverley may be able to use her own capital gains exemption to reduce her future bill on the disposition of the shares

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Question 4 Solution, continued...

Crystallization:

- Steve could consider a corporate reorganization during his lifetime to crystallize the use of his lifetime capital gains exemption.

Vacation Property:

- Principal residence exemption is only available on one property per year, so any use on the exemption will have to consider how best to optimize its use across properties
- Could roll to Bev tax-deferred, might qualify as her principal residence in the future
- No concern for attribution to Steve, assuming he is dead

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Question 4 Solution, continued…

RRSP:

- If RRSP is paid to Steve's estate or to a named-beneficiary other than someone who qualifies for a deferred tax rollover (i.e., spouse or child), the $770,000 proceeds are taxed on his terminal return, resulting in tax of about $385,000, assuming 50% marginal tax rate
- Tax at death could be avoided in advance by changing beneficiary to Beverly, to facilitate a tax-deferred rollover
- Alternately, assuming Beverley is entitled to the RRSP under Steve's will, the estate executor and Beverly can jointly elect rollover treatment
- Either way, proceeds could be taxed to Beverly as she withdraws them from an RRSP or RRIF
- Or, some or all of the RRSP proceeds maybe eligible to roll tax-deferred to an RRSP for Chip

Insurance

Joint last-to-die permanent life insurance on Steve and Beverly may be an option to fund taxes or estate liquidity

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Question 5

Briefly discuss four things that Steve and/or Beverly should explore to provide for Chip’s financial well-being, both for now and later in life.

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Question 5 Solution

RDSP:

- Assuming that Chip qualifies
- Best registered with Beverly as the sponsor – maximize grants and possibly minimize tax implications
- Accumulate funds for Chip's support in later years
- Perhaps after deaths of Steve and/or Beverly
- Contributions may be matched by government grants/bonds
- Contributions grow free of current taxation
- Particularly while Steve and Beverly are not married or official common-law partners
- Could tie up funds that otherwise could be invested for Chip without restrictions

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Question 5 Solution, continued...

RESP:

- Possible back-up plan to RDSP
- Uncertain what Chip's future intellectual development might bring
- Would allow for tax-deferred growth of funds
- Could make Michael an alternate beneficiary
- If not used there would be adverse consequences upon surrender of plan (penalty tax and a requirement to repay government grants)

Life Insurance:

- Need to have life insurance dedicated exclusively to the support of Chip
- For Chip in trust
- Could be joint last to die on Steve and Beverly
- Permanent insurance required

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Question 5 Solution, continued…

Qualified Disability Trust:

- A qualified disability trust (QDT) could be established for Chip in either of Steven/Beverley's wills
- This option is only available via testamentary trust

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Question 6

Outline four specific ways that Charlie and/or Steve might utilize trusts (inter vivos or testamentary), now or in the future, to achieve their estate planning objectives with regard to each other and their children. Be mindful of provincial family law legislation and be specific regarding the rationale behind the use of the trust, the problems that the trust might solve and the advantages/disadvantages of using a trust in the given circumstances.

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Question 6 Solution

Inter Vivos Trust:

- May be appropriate to hold some/all of the common shares of Ruff, if Charlie does not feel that Steve is ready for complete control of the company
- Suitable third-party trustee (not Steve or Frieda, nor both)
- Could provide for capital encroachment and/or progressive distribution of shares as Steve matures

Henson Trust:

- Absolute discretionary trust for Chip's benefit
- At death of Steve or Beverly, or both
- Protects Chip from his (possible) inability to manage funds
- Protects against diminishment of provincial disability benefits
- Could hamstring Chip's access to trust funds if his intellectual capacity grows to the point where he could manage the money himself

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Question 6 Solution, continued…

Testamentary Spousal Trust:

- Steve would likely want to provide for Beverly in the event of his death (she has little income& few assets)
- Possible concern that she has little regard for Steve's children
- If she was given assets outright, they might never reach Steve's children at her death (if Steve were to die first)
- Steve could make his children, and Chip, residual heirs
- Would want to advise Beverly of his plans

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Question 6 Solution, continued…

Spendthrift Trust:

- Charlie might consider placing Frieda’s share of his estate into a spendthrift life trust
- Could include Frieda’s share of the preferred shares of Holdco, if they are to be divided between Steve/Frieda at Charlie’s death
- The trust could provide Frieda with a lifetime income
- Could also provide for capital encroachment
- Could, however, cause resentment on Frieda’s part and alienate her from her brother

Alter Ego/Joint Partner Trust:

- When Steve and Beverly are much older (65+)
- Protect assets against creditors
- Reduce estate value for probate purposes
- Protection against mismanagement of assets in the event of incapacity
- Could restrict their access to funds in their later years