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.

The Facts

Your clients are three generations of the Douglas family:

- the grandfather, Charlie, who has been your client for many years;
- Charlie's son Steve, to whom you were recently introduced and Steve's common-law spouse, Beverly; and,
- Steve's three children from previous marriages.

Charlie, age 64, has been a widower since his long-term spouse (Mandy) died from cancer seven years ago. Charlie and Mandy had two children - Steve and his sister Frieda. Charlie continues to work full-time. He is the sole shareholder of the family business, a private incorporated company that distributes roofing materials. Charlie is seriously contemplating retirement within the next three years.

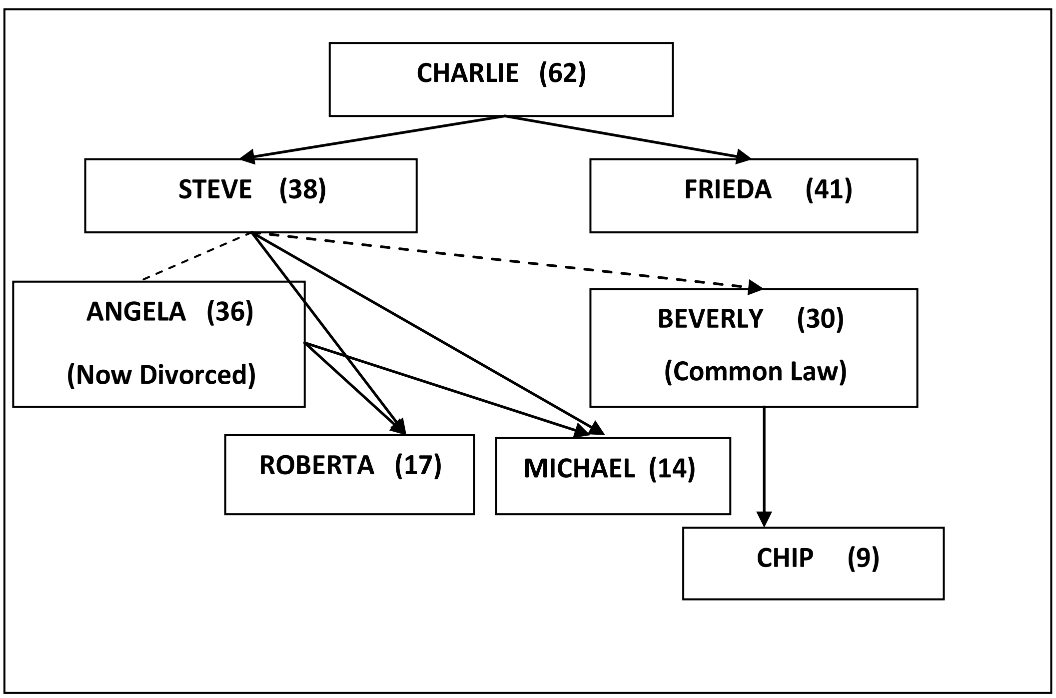
Steve, age 38, works in the family business and was married to Angela for 13 years. Their divorce was finalized two years ago. Together, they have two children – 12 year-old Roberta and 10 year-old Michael, who both live with Angela.

Steve has generous visiting privileges and the children usually spend about four weeks with him each summer; a sore point with Steve's live-in girlfriend, Beverly, age 30. In fact, Beverly confided to you that she "cannot stand" Steve's children from his first marriage.

Six months ago, Beverly and her son Chip moved in with Steve. Steve expects to marry Beverly at some point in the future. Roberta and Michael are both in lower school and anticipate pursuing higher education. Now age nine, Chip was diagnosed with autism at age three. Chip's father died in an automobile accident four years ago, leaving Chip and Beverly on their own.

The relationship among the various family members is illustrated by the following chart.

Douglass Family Chart



Charlie

Charlie is the sole shareholder, President and CEO of Ruff Roof Inc (Ruff), a company that distributes durable materials to replacement roofers. The company was founded and incorporated in 1980. Charlie borrowed $20,000 to purchase 1,000 common shares of the new company, paying $20.00 per share, at inception. No outside capital has been injected into the corporation since it was founded and the $20,000 loan has long since been paid off.

Ruff is now valued at $1,800,000 as a going concern and holds the hard assets shown in Appendix A.

Appendix A
Ruff Roof Inc
Asset Summary

Inventory	$760,000
Equipment	$490,000
Operating Bank Account	$ 80,000
Accounts Receivable	$220,000
Investments	$250,000
	$1,800,000

NOTES:

The $250,000 of investments are GICs that represent Retained Earnings that Charlie has elected to keep invested within the company.

As discussed earlier, Charlie plans to retire within the next three years. He wants to treat each of his children equally through his estate and plans to gift or sell his Ruff shares to them when he retires. In addition to Ruff, Charlie owns a house worth $320,000 and has $230,000 invested in bond funds inside his RRSP. He currently draws an annual salary of $200,000. Charlie is counting on a substantial income from the business during retirement to support his expected lifestyle. Charlie is presently in a 46% marginal tax bracket. He has not used any of his lifetime capital gains exemption, and would like to minimize taxes payable during his retirement and at the time of his death.

Steve

Steve has worked in the family business since graduating from high school, nearly 20 years ago. Lately, Steve has assumed responsibility for managing most of Ruff's day-to-day operations, as Charlie gradually releases responsibilities as he eases his way into retirement. Steve is dedicated to Ruff, and expects to assume full responsibility for all day-to-date operations, and eventually own the business, either at Charlie's retirement or death. Steve is uncertain about how he might afford to buy Charlie out. Steve does have a plan that he would like to implement to buy the storage facility that Ruff currently rents. The plan is to expand the business into related construction product lines.

Steve's divorce from Angela occurred two years ago, although a few facets of the divorce agreement remain unsettled. For example, the two still have joint ownership of a $200,000 vacation property.

Neither Steve nor Angela ever devoted much time to financial and estate planning. They had not saved much for their children's education and have never revised their wills since executing simple mirror wills for outright distributions to each other, and reciprocal powers of attorney for property, shortly after they married.

Steve has no group insurance through the company, but does have a $250,000 term life insurance policy with Angela still named as beneficiary.

Steve met Beverly about one year ago and they started dating almost immediately. Steve's home is mortgage-free and valued at $250,000. He bought Angela's interest in the home when they divorced. Steve and Beverly have no specific date set for marriage but they see their relationship as long term, with marriage at some point in the future. Steve has bonded with Chip, Beverly's special needs child, and his welfare is first and foremost in Steve's mind.

Steve has, in addition to his house, about $150,000 in an RRSP invested in foreign index funds and $40,000 in equity mutual funds. He also intends to purchase a new vacation property of his own about 150 miles north of Toronto within the next few years and hopes to be able to save enough for the down payment out of his $110,000 annual salary.

Outside of his current situation, Steve has concerns for the future. Although Charlie is healthy and in full control of his mental faculties, Steve's mother had cancer and was in the early stages of dementia when she died. He worries about how heredity might impact him in his later years. If he takes over the company in a few years' time, his estate value could grow substantially. He is concerned that, should something happen to him in his 40s or 50s, a substantial estate might pass to his children at a time when they are not ready to handle it.

Frieda

Steve's sister, Frieda, worked for nearly four years in the family business after graduating from university, then left the company to take a job as a floor manager with a department store. Still single at 41, Frieda tends to spend much of her modest salary on travel and entertainment. Living in a rented apartment, Frieda has not built up significant assets and is counting on government benefits and her inheritance to sustain her lifestyle in retirement.

Beverly

Beverly was cautious about entering into a new relationship, but the close bond that Steve formed with her son convinced her that Steve would be an excellent life partner. Left with very little after her husband's death, Beverly was able to move in with Steve on short notice. She works as an assistant in an administration office, but most of her $40,000 salary now goes to shared household expenses and bi-weekly therapy sessions for Chip. After her experience with her husband's sudden death, Beverly took out a $100,000 whole life policy on herself, payable to her estate. Her will names her late husband as executor and beneficiary of the residue of her estate. Similarly, her late husband is named as her attorney, under her power of attorney document for financial assets. These documents have not been revised since her late husband's death.

Angela

Since her divorce from Steve, Angela has devoted her time to raising her two children, Roberta and Michael, who live with her full-time. She is employed part-time in an administrative role with the board of education, earning approximately $28,000 a year. She lives in rented premises and makes do with her net salary and the $2,000 a month she receives from Steve, pursuant to their divorce agreement.

Roberta and Michael

After graduating high school later this year, Roberta plans to enter a four-year nursing program, expecting to work in a free-clinic, funded by the government, for the underprivileged in her community. If so, her salary will be minimal versus what she could earn in a private practice. She plans to work part-time to help defray part of the tuition and room and board. She has only about $3,000 saved towards her education to date.

Michael expects to go to university, and possibly post-graduate school, for a professional degree, but he has not decided what discipline to pursue. He has no savings for education costs.

At present, both children live full-time with their mother and each receives $200 a month in support from their father.

Chip

Chip is Beverley's sole child from her previous marriage. At age nine Chip is non-verbal, but he has learned to communicate with sign language and other methods. Because he lacks verbal skills, it has been difficult to assess Chip's intellectual abilities properly. He currently attends the public school system, in grade three, with the help of a part-time teaching assistant. Steve and Beverly are hoping to get Chip into a private school system specializing in special needs children, but the waiting list is long and annual costs run in the $18,000 range. Until Chip has more dedicated therapy and long-term assessment, it is uncertain whether he will ever be able to function independently.

In the Year 2035

We fast-forward to the year 2035. Upon your earlier recommendation, Charlie executed a section 85 tax-deferred estate freeze of his Ruff shares when he retired, with Steve as beneficiary of the freeze. Charlie passed away several years ago and Steve is now the sole owner of the common shares of Ruff holding company, which now has a fair market value of $3,500,000. The preferred shares of the holding company are owned 50/50 by Steve and a trust set up for Frieda's benefit under Charlie's will and are valued at $1,800,000. The operating company is a qualified small business corporation and neither Steve, nor Frieda, nor Beverly have ever used any of their respective lifetime capital gains exemption.

In addition to his company shares, Steve owns:

- a vacation property, registered in his name, valued at $700,000, purchased for $300,000;
- his home is currently valued at $800,000, and is registered in joint title with the right of survivorship with Beverly.
- $770,000 invested in equities in an RRSP, with his estate as the beneficiary.

Chip, whose intellect never developed beyond age 7, lives with Steve and Beverly full-time and is wholly dependent on them, both financially and otherwise.

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.

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 8.5.1.2.2*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, chapter 18*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 22.3.1*
- *Estate Planning with Life Insurance, 7th Edition, 3.3(c)(iii)*

Existing insurance

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 6.5.4*

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)

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 8.6*

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 3.4.2.6*

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.

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 22.3.6*

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)

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 22.3.6*

Use of Joint Tenancy with Right of Survivorship

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 22.3.1*
- *Estate Planning with Life Insurance, 7th Edition, 3.3(c)(iii)*

Use of Multiple Wills

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 22.3.9*
- *Estate Planning with Life Insurance, 7th Edition, 3.3(c)(i)*

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 22.3.5*
- *Estate Planning with Life Insurance, 7th Edition, 3.3(c)(ii)*

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.

Solution

The question was designed to elicit responses relating to four areas of the case with regard to Charlie's estate:

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

***Reference*:**

- *Estate Planning with Life Insurance, 7th Edition, 5.4*

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

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 16.2.3*
- *Estate Planning with Life Insurance, 7th Edition, 2.5(d)*

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)

Reference

- *Wealth Planning Strategies for Canadians, 2020 Edition, 16.5.2.2*
- *Estate Planning with Life Insurance, 7th Edition, 5.2*

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.

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

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, chapter 21*

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 16.2.3 and chapter 21*

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

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition, 15.1.3*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 21.2.3*

Insurance

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

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.

Solution

Steve (and Beverly) may consider any and all of the following to provide for Chip's security.

Henson Trust

- Fully discretionary trust
- 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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 12.3.1*

Other Testamentary Trust

- If a Henson trust does not apply (not recognized in the province of residence or Chip is not really a candidate)
- Could hamstring Chip's access to trust funds if his intellectual capacity grows to the point where he could manage the money himself
- Restrictions of trust could be mitigated by incorporating a liberal capital encroachment clause

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 12.3*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 12.1.3*

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)

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 10.1.2 & 12.1.4*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 12.4*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 12.3.2*

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.

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 16.5.2.2*
- *Estate Planning with Life Insurance, 7th Edition, 5.2(a)*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 12.3.1*
- *Estate Planning with Life Insurance, 7th Edition, 10.2(b)*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 5.5.2 / 8.5.2.1 / 23.5.6*
- *Estate Planning with Life Insurance, 7th Edition, 3.2(a) & 10.3*

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

Reference:

- *Estate Planning with Life Insurance, 7th Edition, 10.1(b)*

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

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition, 22.3.5.1*
- *Estate Planning with Life Insurance, 7th Edition, 3.3(c)(ii)*