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.

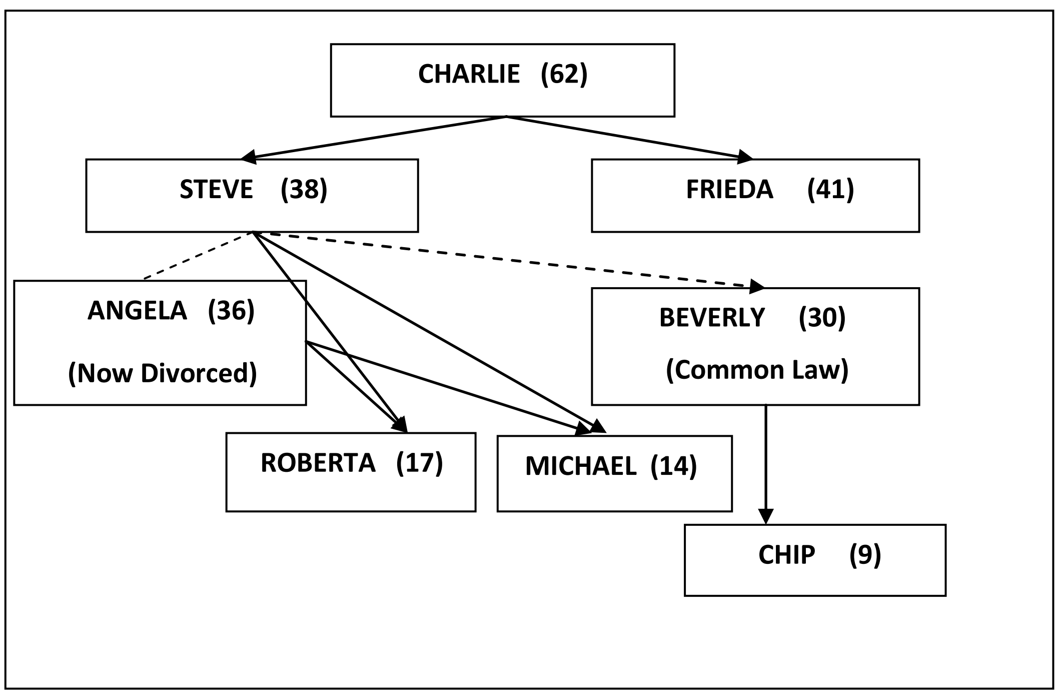
Steve, age 38, works in the family business and was married to Angela for 13 years. Their divorce was finalized two years ago. Together, they have two children – 12 year-old Roberta and 10 year-old Michael, who both live with Angela.

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.

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition: 3.4.2.6; 8.5.1.2.2; 22.3.1; 6.5.4, 8.6; chapter 18*
- *Estate Planning with Life Insurance, 7th Edition: 3.3(c)(iii)*

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.

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition: 22.3.5; 22.3.6; 22.3.1; 22.3.9*
- *Estate Planning with Life Insurance, 7th Edition: 3.3(c)(iii); 3.3(c)(ii); 3.3(c)(i)*

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.

***Reference*:**

- *Estate Planning with Life Insurance, 7th Edition: 2.5(d); 5.2; 5.4*
- *Wealth Planning Strategies for Canadians, 2020 Edition: 16.2.3; 16.5.2.2*

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.

***Reference*:**

- *Wealth Planning Strategies for Canadians, 2020 Edition: chapter 21; 15.1.3; 16.2.3; 21.2.3*

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.

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition: 10.1.2; 12.1.3; 12.1.4; 12.3; 12.3.1; 12.3.2; 12.4*

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.

Reference:

- *Wealth Planning Strategies for Canadians, 2020 Edition: 5.5.2; 8.5.2.1; 12.3.1; 16.5.2.2; 22.3.5.1; 23.5.6*
- *Estate Planning with Life Insurance, 7th Edition: 5.2(a); 10.1(b); 10.2(b); 3.2(a); 3.3(c)(ii); 10.3*