Advanced Estate Planning

CLU 257

The Institute™
for Advanced Financial Education

Advanced Estate Planning

Course 257

2017 Edition

by

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Preface

This material provides a study guide and case studies to accompany the assigned readings from the two textbooks: *Estate Planning with Life Insurance*, 6th Edition by Glenn R. Stephens, LL.B., and *Wealth Planning Strategies for Canadians* 2018 by Christine Van Cauwenberghe, B.Comm., LL.B., CFP, TEP. There is no assigned reading from the textbooks for study unit six; the assigned reading is provided within unit six of this study guide.

It is expected that each candidate will already have some professional experience and educational background in many of the topics included in each of the study units. The assigned reading material is intended in large part to serve as a review of topics of which the candidate should already have knowledge and understanding. To this end, the course material includes several appendices, to allow candidates either to review relevant course content, fill in knowledge gaps, or update knowledge where the law has changed in the respective area.

The study units are designed to help the candidate pull together broad areas of information and apply them in an integrated fashion to client cases that approximate real-life practice. As would be the case in actual practice, it is expected that each practitioner may have more detailed knowledge in his or her area of expertise. The lawyer will know the rules and formalities to be followed in order for a will or power of attorney to be legally binding. The accountant will know the deadline for filing estate tax returns and making income tax payments. The financial planner will be able to project spending and wealth accumulation; determine funding requirements for retirement, dependents and estate purposes; and predict estate value. Trust officers will be intimately familiar with the details of estate administration and managing the assets of an incapable person, and the duties and obligations of attorneys, trustees and executors. The insurance professional can structure insurance solutions to fund obligations on death and achieve estate planning objectives and preserve wealth. While these are all aspects of estate planning, they are not the complete picture. This course provides an overall perspective of multiple aspects of estate planning so that each professional understands the context within which his or her work is performed. The extensive use of case studies is intended to allow a candidate to analyze client situations that include a variety of information, identify the salient items, and propose solutions or determine where issues arise that would require consulting a practitioner from another field.

As was noted in previous courses, while many of the relevant laws or rules in provincial jurisdictions are similar, jurisdictional differences may nonetheless exist that significantly affect a client's situation. In many cases, the Study Guide and assigned readings will highlight these instances; however, the reader is responsible for learning the specific law applicable in his or her jurisdiction, and must not rely on this material for the provincial or territorial specifics relating to his or her practice. For the purpose of examinations, the answers to questions will not require any specific provincial or territorial details beyond either the content of this material, or information that may be provided in an examination question itself.

Acknowledgements

The Institute would like to thank members of STEP Canada[1] and the STEP Canada Education Committee for having generously volunteered their time and expertise to enhance the scope, clarity and accuracy of the contents. Britta McKenna of Hodgson Russ LLP reviewed the U.S. content in Study Unit Six and the respective assigned reading. Christine Van Cauwenberghe, B.Comm. (Hons), LL.B., CFP, TEP and Glenn Stephens, LL.B., generously provided their support and comments.

The Institute would also like to acknowledge the efforts of the CLU Advanced Estate Planning Task Force and members of the Education Committee who reviewed the content to confirm that the learning objectives of the course were being met, and to ensure that the course met the high standards of the CLU designation program.

Where indicated, additional source material has been provided with the permission of STEP Canada or The Institute, and has been excerpted or modified for the purposes of this course. Given the dynamic nature of the laws and regulations that apply to this area, the reader should be alert to relevant future changes.

The Institute for Advanced Financial Education
Toronto, Ontario
2017

1 STEP (Society of Trust and Estate Practitioners) is the leading international organization for practitioners in the field of trust and estate planning, including lawyers, accountants, financial planners, insurance advisors and trust professionals, and confers the TEP designation on the most experienced members. STEP Canada has branches in the major Canadian cities and provides education, training, representation and professional development activities for its members.

Study Directions

The course is divided into seven study units, with the final unit devoted to case studies.

Prescribed Text

Text references in this study guide are to:

- Estate Planning with Life Insurance, 6th Edition by Glenn R. Stephens, LL.B.; and
- Wealth Planning Strategies for Canadians 2018 by Christine Van Cauwenberghe, B.Comm., LL.B., CFP, TEP

Unit review questions and answers

You will find a number of questions at the end of each study unit. Suggested answers are provided after each set of questions. We encourage you to attempt to answer each of the questions before you refer to the answers. These questions are intended to assist you in your study efforts. They are not the kind of question you will encounter on the assignments and final exam.

Glossary

Key terms are defined and listed alphabetically at the end of this study guide.

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- Each assignment is worth 20% of the overall course mark overall.
- Each assignment corresponds with specific sections in this study guide.
- Each assignment will require narrative responses to each question.

Final Exam

After completing both assignments, candidates are required to complete an exam covering all study units. **Please be advised that the three-hour proctored exam will be paper-based and held at an assigned time and location.**

Please note the following:

- The final exam is worth 60% of the overall course mark.
- Candidates will be notified of their exam date at registration.
- The exam will require narrative responses to each question.

The Exam is worth 60% of the final overall course mark, along with a total of 40% for the Term Assignments. However, **you must achieve a minimum mark of 50% on the exam in order to pass the course.**

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Problems or clarifications regarding course content Please contact our course consultants at:

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Table of Contents

PREFACE . . . . **iii**

ACKNOWLEDGEMENTS v

STUDY UNIT ONE – THE ESTATE PLANNING PROCESS

1.1 Introduction 1-4
1.2 Benefits of Following the Estate Planning Process 1-5
1.3 Identifying the Steps in the Estate Planning Process 1-6
1.4 Particular Requirements for Each Professional 1-7
1.5 The Importance of Disclosure 1-7
1.6 Using Checklists and Forms 1-11
1.7 Relationship Between Analysis and Identifying Objectives 1-13
1.8 Uncovering Motives and Identifying Objectives 1-14
1.9 Professional Advisors and the Team Approach 1-15
1.10 Estate Distribution 1-16
1.11 What If's 1-17
1.12 Common Pitfalls and Drafting Errors in Preparing Wills 1-18
1.13 Summary of Key Issues 1-19
1.14 Terminology 1-21
Review Questions and Answers 1-22

STUDY UNIT TWO – PERSONAL ESTATE PLANNING

2.1 Introduction 2-7
2.2 Charitable Giving 2-7
2.3 Creditor Protection 2-12
2.4 Planning for Incapacity 2-14
2.5 Probate Fee Planning 2-15
2.6 Will Planning 2-19

2.7 Taxation at Death 2-22
2.8 Planning with Trusts 2-26
2.9 Summary of Key Issues 2-31
2.10 Terminology 2-32
Review Questions and Answers 2-34

STUDY UNIT THREE – FAMILY ESTATE PLANNING

3.1 Introduction 3-5
3.2 Commentary on Assigned Readings and Assigned Case Studies 3-7
3.3 Summary of Key Issues 3-31
3.4 Terminology 3-33
Review Questions and Answers 3-34

STUDY UNIT FOUR – BUSINESS ESTATE PLANNING

4.1 Introduction 4-4
4.2 Business Estate Planning 4-4
4.3 Commentary on Assigned Readings and Case Studies 4-21
4.4 Summary of Key Issues 4-24
4.5 Terminology 4-26
Review Questions and Answers 4-27

STUDY UNIT FIVE – ESTATE PLANNING WITH LIFE INSURANCE

5.1 Introduction 5-3
5.2 Estate Planning with Life Insurance 5-3
5.3 Terminology 5-10
Review Questions and Answers 5-13

APPENDIX 5.1 Excerpt from the Advocis LLQP 2017 TFAAC material,
Life Insurance Products 5-19

STUDY UNIT SIX – FOREIGN ASPECTS OF CANADIAN ESTATE PLANNING

6.1 Introduction 6-5

6.2 Impact of Foreign Laws on Canadian Estates – Overview 6-5

6.3 U.S. Estate and Gift Tax for Canadians – Overview 6-11

6.4 U.S. Estate Tax Planning for Residents of Canada Who Are Not U.S. Citizens 6-26

6.5 Summary of Key Issues 6-29

6.6 Terminology 6-30

Review Questions and Answers 6-32

APPENDIX 6.1 STEP Diploma Program, *Wills, Trust and Estate Administration*, Wendy D. Templeton, Chapter 14, Foreign Property, Multiple Jurisdictions and Succession . . . 6-39

STUDY UNIT SEVEN – CASE STUDIES

7.1 Case Study Scenarios 7-2

7.2 Answers to Case Studies 7-8

GLOSSARY Glossary-1

STUDY UNIT ONE

THE ESTATE PLANNING PROCESS

Knowledge Objectives

Skills Objectives

Topics Covered

Related Textbook Readings

1.1 INTRODUCTION 1-4

1.2 BENEFITS OF FOLLOWING THE ESTATE PLANNING PROCESS 1-5

1.3 IDENTIFYING THE STEPS IN THE ESTATE PLANNING PROCESS 1-6

1.4 PARTICULAR REQUIREMENTS FOR EACH PROFESSIONAL 1-7

1.5 THE IMPORTANCE OF DISCLOSURE 1-7

1.6 USING CHECKLISTS AND FORMS 1-11

1.7 RELATIONSHIP BETWEEN ANALYSIS AND IDENTIFYING OBJECTIVES 1-13

1.8 UNCOVERING MOTIVES AND IDENTIFYING OBJECTIVES 1-14

1.9 PROFESSIONAL ADVISORS AND THE TEAM APPROACH 1-15

1.10 ESTATE DISTRIBUTION 1-16

1.11 WHAT IF'S 1-17

1.12 COMMON PITFALLS AND DRAFTING ERRORS IN PREPARING WILLS 1-18

1.13 SUMMARY OF KEY ISSUES 1-19

1.14 TERMINOLOGY 1-21

REVIEW QUESTIONS AND ANSWERS 1-22

Study Unit One

The Estate Planning Process

Learning Objectives

Knowledge Objectives

Upon completion of this unit the student will:

- Understand the estate planning process
- Understand how the estate plan fits into the client's overall situation
- Know the common problems associated with poor communication
- Explain the problems that may result from failure to consider future events

Skills Objectives

Upon completion the student will, in relation to the topics listed below, be able to:

- Analyze the client's financial status and overall estate planning objectives
- Identify the steps in the estate planning process
- Explain the advantages and disadvantages of different estate planning strategies and contrast them with one another
- Conduct the six step financial planning process and decide on the critical components of the client's plans and objectives
- Assess the tax implications
- Assess the family law/succession law implications
- Assess estate creation initiatives
- Assess estate conservation initiatives
- Assess retirement and disability considerations
- Assess liquidity issues
- Assess death and equity issues
- Design a financial and estate plan to address the client's objectives
- Recommend strategies for pursuing the financial and estate plan
- Design the plan to fit the client and avoid common pitfalls
- Describe how unexpected events might disrupt the estate plan

- Explain how the estate plan fits into the client's overall family and financial situation
- Determine whether or not the client (including spouse, child, parent or beneficiary) is a U.S. citizen

Topics Covered

Process

- Discovery
- Analysis of Information
- Identifying Objectives
- Obligations
- Identifying Strategies
- Choosing/Deciding Strategies
- Distribution Schemes
- Implementation and Follow Up
- The Advisor Team
- Overcoming Resistance and Procrastination

Designing the Estate Plan to Fit the Client — Avoiding Pitfalls

- Putting the Whole Plan Together
- Client Communication
- *Inter Vivos* Planning/Gifting
- Common Drafting Problems in Wills

Related Textbook Readings

Estate Planning with Life Insurance
Glenn R. Stephens, LL.B.

Chapter 1 The Role of the Insurance Professional in the Estate Planning Process

Wealth Planning Strategies for Canadians
Christine Van Cauwenberghe, B.Comm. (Hons), LL.B., CFP TEP

Chapter 1 Introduction to Wealth Planning

1.1 INTRODUCTION

Mastering the planning process is the key to success for all advisors in the financial and personal planning sectors. Engaging the client in an effective planning process draws on the advisor's particular expertise as well as interpersonal skills. The Financial Planning Standards Council of Canada defines the financial planning process as:

> The process used in providing *Financial Planning* services and normally includes establishing the engagement; gathering data and establishing goals; identifying the present financial situation, potential problems and opportunities; developing and recommending strategies to meet the client's needs and goals; implementing the recommended strategies; and reviewing and revising the strategies and actions on a periodic basis.

The steps in the estate planning process are no different. The value of having a process that is followed as a regular part of one's practice cannot be over-emphasized. A good advisor brings his or her own professional expertise to the process, whether in the field of financial planning, law, accounting, insurance or other specialty. But whatever the particular professional skill or role in the process, the advisor who works in the estate planning field must also be one part detective, one part financial analyst, and one part psychologist. Estate planning is unique in that it encompasses all the client's affairs and requires an understanding of the client's motives, personality, values, family, and financial and business affairs. In other planning areas, the client may be able to "compartmentalize" the information communicated and isolate one advisor from the other. This is not the case in estate planning.

Estate planning has been likened to a medical diagnosis and treatment. While estate planning is not a disease (though clients sometimes avoid it as if it were), the analogy is a good one. A medical history and symptoms must be gathered (disclosure). Medical tests may be carried out (analysis and issue identification), a diagnosis will be made and treatment discussed (identifying strategies and recommendations), and treatment administered and recovery monitored (implementation and follow up).

Clients sometimes resist disclosure. It can be time consuming to find all the documents and information required and not all clients are willing to share so much personal information about their wealth and their family situation. It may

be appropriate to use the medical analogy. "If you were sick and went to the doctor, all your medical history and symptoms would be needed to treat you. In the same way, I need a lot of information to properly assist you and develop an estate plan best suited to you and your circumstances." Full disclosure is needed to do effective estate planning just as it is to treat a medical condition and restore a patient to health.

This study unit is not intended to review the substantive law relating to estate planning. Its purpose is to provide a framework within which the expertise may be applied to a particular client's situation, so that an estate plan appropriate for the client's situation and objectives can be designed and implemented. The most skilled experts would do their clients a great disservice, and expose themselves to potential liability, if any plan, no matter how simple or sophisticated, were implemented without engaging in the process discussed in this unit. The process ensures the plan fits the client's needs and circumstances. Estate planning is like a custom-made suit — one-size-fits-all will not work. Even if the client ends up with an "off the rack" Will based on a precedent document without any major variations, the process is essential to determine if this is what is appropriate. Without completing the estate planning process, the client may be no better off than drafting his or her own Will from an Internet form or a Will kit. The process ensures that appropriate advice and expertise shape the plan to fit the client.

1.2 BENEFITS OF FOLLOWING THE ESTATE PLANNING PROCESS

The estate planning process reaps many benefits for the advisor, the client, and his or her family. The benefits include those outlined below.

- **Risk Management:** Errors that may result from poor communication, undisclosed information, or inaccurate information can be minimized with an effective planning process.
- **The Right Plan for the Client:** The planning process avoids the "one-size-fits-all" approach to planning and insures that the plan suits the client's situation, needs and objectives, and is consistent with the client's values.
- **Opportunity Optimization:** Planning opportunities that are not readily apparent can be uncovered during the course of a thorough process that is investigative rather than close-ended.

- **Grateful Clients and Repeat Business:** One of the best ways to build business is through referrals by satisfied clients. A good estate planning process will give clients confidence in the service they have received, and provide opportunity for the advisor to ask for and receive referrals.
- **Ensure Capacity:** The process permits the advisor an opportunity to test the client's capacity and his or her ability to make decisions free from undue influence.
- **Accountability:** A record is provided through the process for future scrutiny if the Will or any aspect of the plan is later challenged.
- **Details Available:** Following the process provides information that may be critical in the administration of the estate.

1.3 IDENTIFYING THE STEPS IN THE ESTATE PLANNING PROCESS

The steps in the estate planning process are similar to those in the financial planning process. While the labeling and categorization of the steps in the process, and the order in which they take place may vary slightly from one discipline to another, and indeed from one advisor to another, the following is a fair example of the steps in the process.

1. Disclosure and verification
2. Identifying Objectives
3. Analysis
4. Identifying strategies
5. Evaluating strategies and making recommendations
6. Deciding on the plan and taking instructions
7. Implementation
8. Review and follow up

An examination of these steps reveals immediately that the planning process is a collaboration between the advisor and the client. In many cases more than one advisor or professional will be involved, and more than one person within the client's family circle may participate in identifying objectives and assisting in the

decision-making process, providing always of course that the client makes his or her own decisions free from undue influence. The role of the advisor is not to simply mechanically gather and record information and produce legal documents that parrot the client's stated objectives without further inquiry or dialogue. It is in the dialogue between the advisor and the client that the process takes life and the real issues can emerge. The advisor's skill and expertise can then be employed to guide the client to identify the real issues, and then design the appropriate strategies.

1.4 PARTICULAR REQUIREMENTS FOR EACH PROFESSIONAL

It should be noted that the profession the advisor practices may have its own standards regarding the process. The Financial Planning Standards Council of Canada has particular prescribed planning steps and practices. In the investment field, there are strict "know your client rules" to which licensed investment advisors must adhere. Lawyers are also subject to special rules when engaging in estate planning, including special requirements for joint retainers, and obligations to probe for capacity and take steps to prevent or detect undue influence or fraud. Legislation has now been introduced in Canada relating to money laundering and anti-terrorism. These new laws impose requirements relating to client identification, and reporting of certain cash or suspicious financial transactions. It is expected that each student will be fully aware of his or her own particular professional requirements in addition to information in this study guide and the required reading.

1.5 THE IMPORTANCE OF DISCLOSURE

Disclosure has several aspects including hard facts and more subjective information relating to the client, often referred to as "soft" information. Details of "hard" and "soft" information are discussed in some detail in the *Life Insurance* text and included in the terminology section of this Study Unit.

The factual information, sometimes called "hard" information, includes the list below.

- **Assets:** This covers information about the client's property, and all the details of such property including tax attributes (i.e., cost, date of acquisition, etc.), value, ownership, beneficiary designations, and the like.

- **Personal Information about the Client:** These details include place of residence, marital status, date of birth, and citizenship to name some obvious details.
- **Relationships:** This refers to information about the client's family situation. This involves identifying the client's immediate family members, and dependants along with the more extended family tree. This information will be key when the client is considering the obligations under family and dependants' relief law, possible beneficiaries, possible executors and attorneys under powers of attorney, and possible persons who may be the beneficiaries of a common disaster clause in the event the primary beneficiaries all die before the client, or before the funds in any testamentary trusts created in the Will are fully distributed.
- **Legal Arrangements:** Any legal arrangements that the client has entered into should also be the subject of disclosure. These would include marriage contracts, separation agreements, trust arrangements, shareholder agreements, partnership agreements and previous estate planning arrangements such as estate freezes or alter ego or joint partner trusts.

The soft information relates more to the client's personal views and values. While these can be described as factual, they also will influence the part of the process where objectives are identified and decisions are made concerning the choice of beneficiaries, and which strategies are to be utilized to achieve particular objectives. For example:

- Does the client support charitable organizations or causes and is this a priority in the estate plan?
- Does the client have any strong objections or concerns about a particular family member that might affect the benefit that person receives from the estate?
- Does the client have a strong desire to minimize and defer taxes even though this may make the estate plan more complex or more costly?
- Does the client wish to control or protect the transfer of wealth that passes to beneficiaries, or is there a desire to divide and

distribute immediately, leaving beneficiaries completely free to use the inheritance how and when they decide without any protection from themselves or third parties?

Errors may result from failure to obtain all the information and ensure its accuracy. These may include:

- failure to obtain accurate information about how property is held (legal title),
- failure to get all the relevant information because a thorough checklist or other systematic fact finding process is not followed, and
- failure to uncover a client's true wishes or hidden agenda that would shape the objectives and recommendations.

A married or common-law couple may confuse ownership of property as between themselves. Or it may be assumed that an asset is held personally, when in fact it may be held by a corporation, a trust, or other person or entity. These are common mistakes that clients make themselves as they may not appreciate the importance of legal ownership for the purposes of estate planning. The role of the advisor, however, is to ensure that the plan is consistent with the client's holdings. If property is the subject of a specific gift, but it is held jointly with a right of survivorship, or there is a beneficiary designation, any gift of such property in the Will fails. Similarly, if an asset is held by a corporation or trust rather than by the testator personally, the gift in the Will fails and the solicitor, or other advisor could be at risk vis à vis a disappointed beneficiary.

The degree to which a client's information is "audited" by the advisor is always a judgment call by the advisor. The client is often not fully aware of all the details of title for personal holdings. Other advisors such as the client's accountant, business advisor, business partner, spouse, or other family member may be better aware of the particulars. Financial statements, tax returns, existing Wills and Powers of Attorney, account statements, and insurance policies may all be reviewed to assist in completing and verifying the information. The advisor must consider how reliable the information given is, and the consequences that may result if the information is incomplete or inaccurate. Some examples are listed below.

- **Specific Gifts:** If an asset is the subject of a specific gift and is significant to the overall estate plan, the advisor would be advised to

verify the ownership by checking the account statement documents or title in the case of real property and the value of the property as well as the tax attributes.

- **Title to Real Property:** This may be particularly important as title may be held in the sole name of the client, or in joint names either with or without a right of survivorship.
- **Beneficiary Designations:** Verification of beneficiary designations may also be appropriate as failure to account for this may disrupt the plan of distribution.
- **Forms and Checklists:** Where forms and checklists are used they should always be reviewed with the client who may easily have omitted important information that can be disclosed in the course of an interview. It never hurts to ask — several times even — is there anything else (referring to beneficiaries, assets, priorities, etc.)?
- **Hidden Agenda:** If the client is anxious to have the process completed quickly there may be an undisclosed issue such as terminal illness or other hidden agenda. If the urgency is real, an astute advisor may pick up on this and be able to respond appropriately by either expediting the process, or finding another advisor who can complete the work immediately. If the client dies before the plan is fully implemented the advisor could face a claim for negligence by a disappointed beneficiary.
- **Other Hidden Agenda:** There may be other emotional "hidden agenda" items such as concern over difficult beneficiaries that the client is reluctant to reveal. These may be picked up where the client is inconsistent regarding objectives, asks vague questions, or requests certain planning strategies without providing an appropriate rationale. It may be important to permit the client to share concerns in confidence so the advisor may provide solutions. There may be an issue regarding the stability of the marriage of the client or that of one of the children. A child with an addiction problem or in circumstances embarrassing or shameful to the parent may be difficult for the parent to discuss. Such circumstances should be uncovered tactfully where possible so the appropriate remedial recommendations can be offered to the client for consideration.

It may not be sufficient in all cases for the advisor to hide behind an exculpatory clause in a report that says "all information on which your plan/Will has been prepared is provided by you and not verified by us." This does not mean that such a clause is not to be utilized, but the "fine print" should not be a substitute for making reasonable inquiries. The advisor must always rely to a great extent on information provided by the client, and the client should understand the importance of reviewing the information that is provided and checking it for accuracy. Where forms and checklists are used to gather information, it may be a reasonable practice to have the client "sign off" on these documents once they are completed.

1.6 USING CHECKLISTS AND FORMS

Checklists and information forms can be very helpful to ensure all the relevant information is gathered. They are not a crutch for the novice. Rather, they are a tool that ensures important questions are not left unasked and that the plan is executed competently. They can prevent mistakes, and provide protection for the advisor in the event of a future dispute about what information was disclosed. Most estate planners use some form of fact finding form or checklist both for client information and to ensure documents are complete.

Even where checklists and forms are not used, a protocol should be in place to keep a record of the information gathered and the discussions with the client.

Examine the "Estate Planning Factfinder Personal Data" in the *Life Insurance* text. While this form is designed particularly for insurance, it is representative of the type of form a lawyer or financial planner might use. Many such forms are available on websites of estate planning lawyers and financial institutions. The forms vary according to the purpose of the form, and the area of expertise of the professional.

Checklists or forms for lawyers preparing Wills and Powers of Attorney should also contain sections relating to the client's ability to give instructions (i.e., capacity), and undue influence. See for example, the checklists that are on the website of the Law Society of British Columbia. The form for "testator interview" collects information organized under the following categories:

- information about the testator's family,
- information about the testator's estate,

- testamentary capacity,
- fraud, undue influence, suspicious circumstances,
- testamentary wishes, and
- attestation clause (where special note is made of the formalities and language that must be used where testator's ability to sign a Will is compromised due to factors such as blindness or inability to speak English or French, as the case may be).

Additional information that should be verified and on the form or checklist for Will preparation that might otherwise be overlooked may include:

- Are any of the proposed executors non-residents of Canada?
- Are any of the beneficiaries non-residents of Canada?
- Is the client or any family member a U.S. citizen or a U.S. Green Card holder?
- Are there any step-children or children born out of wedlock in the family?
- Has the client any children from a previous relationship?
- Are there any obligations arising from a separation agreement or marriage contract?
- Are there any personal articles or other assets that the client wants to be left to a particular beneficiary?
- Are there any beneficiaries who receive, or may be entitled to receive, provincial disability benefits?
- Are there any concerns with respect to any beneficiary's ability to manage the inheritance?
- Are any of the assets of the client subject to a contractual obligation that would restrict gifting such as a right of first refusal or a buy/sell agreement?
- Is the client likely to come into a large inheritance in the future that would significantly affect the size of the estate?

Even if such questions are not on a form or checklist, these questions are ones that should come up in the course of the interview with the client. Appropriate use of forms and checklists combined with a probing client interview will improve the quality of advice that the client receives. These may also protect the advisor if in future he or she is accused of failing to identify a particular fact or relevant issue. The records in the file, including the advisor's notes of the interview and the checklist and any form completed by the client, may help determine whether the issue was disclosed or addressed. Thus the advisor may be protected from potential liability where the error arose from the client's own failure to provide complete and accurate information. The notes may also assist in administering the estate by identifying assets or clarifying the testator's intention.

1.7 RELATIONSHIP BETWEEN ANALYSIS AND IDENTIFYING OBJECTIVES

Once all the information — both "hard" and "soft" — is gathered, the advisor must analyze the information and have a dialogue with the client regarding objectives. Much of the disclosure process can be done in advance of meeting with the client, if a form or checklist is sent to the client in advance and returned to the advisor. However, analysis and identifying objectives should be done with the client in a face-to-face interview. The first interview with the client is critical to the success of the process and the quality of the plan.

It is at this stage that any discrepancies or gaps in information can be identified and remedied. In addition, it is possible at this stage to identify what property the client may have control over by Will, and what property will pass outside the estate. This distinction is extremely important and is often overlooked by advisors. Property passing outside the estate is not subject to the distribution set out in the Will and will include:

- property for which a beneficiary designation may be made,
- jointly held accounts or real property with a right of survivorship (unless there is a special arrangement whereby it is intended such property be administered as part of the estate by the surviving joint owner),
- property already held in a trust such as an alter ego or joint partner trust, and
- property held through a corporation owned by the client.

If there are registered assets such as RRSPs, RRIFs or TFSAs, these can pass to a named beneficiary or a contingent beneficiary under a beneficiary designation. If there is no designation, the plan proceeds will fall into the estate. The tax consequences of these plans must also be accounted for in determining the value of the estate and assets to be distributed to beneficiaries from all sources.

The examination of all information will assist in determining how or whether a client's stated objectives are obtainable or desirable. For example, the client may state specific goals, but the size of the estate may not warrant such an objective. Setting up a charitable foundation, for example, is only worthwhile if a certain threshold of assets is available to fund it. Short of such funding, the cost may be prohibitive and other charitable giving options, such as a self-directed gift to a community foundation, might be recommended as a more practical alternative. On the other hand the client may want something very simple and for the estate to be immediately distributable on death, whereas the tax planning opportunities or circumstances of certain beneficiaries cry out for the recommendation of a trust.

1.8 UNCOVERING MOTIVES AND IDENTIFYING OBJECTIVES

Clients will often state their objectives in the form of a solution or strategy, rather than in terms of a planning objective. A statement that "I want a spousal trust" looks like an objective. However, the advisor will recognize that this is a strategy not an objective. Probing is required to uncover the objective. What is the purpose of the spousal trust? Is it to preserve capital or is the client making the statement because he or she has heard of someone else who has one and assumes that the same strategy provides benefits to everyone, regardless of their personal circumstances? Once the true objective is identified, the advisor can identify the appropriate planning solution which may or may not be a spousal trust (or whatever strategy the client has proposed).

Another common statement is the desire to disinherit a child or other beneficiary. Probing by the advisor can uncover the reason. For example, if the individual cannot manage money, it may be appropriate to recommend a spendthrift trust rather than no inheritance at all. Or, instead of the particular beneficiary receiving the inheritance, perhaps the client may want to consider skipping a generation and leaving what would be that beneficiary's share (in the case of a child) to that person's children, or spouse or other family member.

The advisor may uncover the fact that the client has a grudge against a particular family member that may be the product of influence by another beneficiary who stands to profit from the client's decision. An inquiry then might be appropriate to determine whether the decision to "cut out" a person from the Will is truly the client's wish or whether there is undue influence that has so "poisoned" the client's mind that the decision is not voluntary.

The analysis of family and financial information should include an examination of the following issues:

- the tax implications, including identifying problems and planning opportunities;
- the rights of a spouse and other family members arising on death under family law and dependants' relief legislation;
- insurance needs to provide for dependants, provide liquidity, achieve "estate equalization" among beneficiaries, and pay taxes and other expenses of the estate; and
- in some cases it may be appropriate to include retirement and disability considerations if these have not been addressed already.

1.9 PROFESSIONAL ADVISORS AND THE TEAM APPROACH

Many disciplines and advisors may participate in the estate planning process. The client should be encouraged to permit the various advisors to share information and co-operate with each other in a non-competitive environment. There are two objectives with the team approach. On the one hand, the client should not pay for duplicated efforts, but on the other there should be no "gaps" in the process where issues or details are omitted because each advisor expects the other has addressed them. It is helpful if at least one advisor takes the lead in the process and is responsible for making sure these pitfalls are avoided. That lead advisor can be the primary person who works directly with the client in reviewing the recommendations and assisting the client to make decisions.

In some cases, particularly where there is a family business, the client may have a "trusted advisor" to whom the client will turn for advice. It may be an accountant, business partner or family member. That special person may not have estate planning expertise, but must be part of the team to help the client make or confirm

decisions. The trusted advisor may also be key in assisting the other advisors as he or she often has invaluable information about the client's preferences, philosophy, personal life, or financial affairs.

When working with a team of advisors it is also important to keep in mind that there is no monopoly on good ideas, and often not all advisors have the same information or perspective. As noted in the *Life Insurance* text, it is important not to make assumptions about another advisor's expertise.

1.10 ESTATE DISTRIBUTION

The way in which an estate is distributed varies with each individual. The bulk of wealth may pass outside the estate if there has been aggressive probate fee planning. Within the Will the client may decide to distribute specific assets by way of specific gifts to individual beneficiaries. This can make the Will challenging to draft as difficult decisions may need to be made as to how the specific property is to be dealt with if the primary beneficiary dies before the testator, or the specific property is no longer owned at the time of death. One common method of distribution is to use a residual clause with division of the estate into equal parts, with each beneficiary to receive a certain number of such parts. If the beneficiary dies before the testator, the parts created for that particular beneficiary are extinguished so that each of the equal parts remaining to be distributed to other beneficiaries have a greater value. This technique reduces the need for excessive "gift over" provisions in the Will and makes it easier for the lawyer to draft (thereby reducing the likelihood of errors) and easier for the testator to understand. A hotchpot clause can be added to reduce the distribution to any particular beneficiary to take into account the value of specific gifts or property passing outside the estate, where appropriate.

One method of testing an estate plan is to demonstrate how property will pass inside and outside the estate to all the client's beneficiaries after payment of debts, funeral costs, executors' fees, probate fees or taxes, income taxes, and other costs of liquidating and administering the estate. Estimating the cost of dying and ensuring sufficient liquidity is available to pay all expenses and specific legacies is part of the process. However, charting it out and showing each beneficiary's actual inheritance can greatly assist the client visualize the final result. In some cases the result may not be what was intended and adjustments may need to be made to the Will, beneficiary designations, or title to assets. Using a hotchpot clause in

a Will can provide a method for adjusting a particular beneficiary's inheritance based on a formula that uses the values of assets at the time of death.

Occasionally the client will ask the advisor how the estate should be divided and distributed among family members and other potential beneficiaries. The advisor can provide guidance but should be careful to support the client's own decision-making process and not substitute his or her own opinion where the client is uncertain. This can often be done by suggesting several alternative approaches and discussing the consequences of each, providing the client with a framework within which an informed choice may be made.

1.11 WHAT IF'S

An estate plan must be tested by running through all the future or unexpected events that could take place without any assumptions. Such unanticipated events may include:

- an "out of order death," such as when a beneficiary dies before the testator, or before any trust has been fully distributed;
- the value of the estate collapses or increases significantly due to inheritance or windfall;
- the testator no longer owns property that is the subject of a specific gift;
- the testator dies immediately or only after an extended period;
- the marital status of family members changes; or
- new family members are born.

It is always possible to change a Will if the testator is still competent, and a review of the plan should be completed every 3 to 5 years or where the client's personal situation changes. However, the plan should anticipate some degree of change and unanticipated events and make appropriate alternate dispositions to the extent possible. A client may not review or change the Will, or may become incapable. If there is a common accident and one family member dies, and the client is injured and unable to make changes, the existing Will must stand on its own.

1.12 COMMON PITFALLS AND DRAFTING ERRORS IN PREPARING WILLS

A review of insurance claims against solicitors for errors and omissions in estate planning reveals that one of the most common sources of problems is poor communication between the client and the advisor. There is no limit on the potential source of mistakes, which is one reason the estate planning process is so important. The following factors, whether made by solicitors or other advisors, can result in serious errors or omissions and may also result in liability.

- Failure to identify all the relevant information and verify accuracy.
- Failure to provide for all the reasonable "what if's" as mentioned above.
- Failure to identify the client's true objectives by probing stated objectives and wishes.
- Failure to co-ordinate or account for property passing inside and outside the estate.
- Failure to properly identify the tax liabilities and tax planning opportunities.
- Failure to make sure the plan fits the client and the client understands all the consequences.
- Failure to ensure the client has made good choices regarding the choice of executors, including their ability to manage the administration, gain the confidence of the beneficiaries, and co-operate with each other.
- Failure to provide the client with a final report that summarizes the plan and provides a final opportunity for both the advisor and the client to identify errors, problems or any misunderstanding regarding the plan.
- Failure to adequately identify property that is the subject of a specific bequest.
- Failure to check the title of property that is the subject of a specific bequest to ensure it passes to the beneficiary as intended.
- Failure to check beneficiary designations.

- Failure to properly identify a beneficiary in a Will or beneficiary designation (with multiple family members or charities more than one may have the same or similar names).
- Confusing "children" or another class of persons with "issue," such as an error making a gift to "my children in equal shares *per stirpes*" instead of "my issue in equal shares *per stirpes*." A Will that distributes to "children" on a *per stirpes* basis is incorrect — a *per stirpes* distribution can only be made to "issue."
- Confusing "per capita" and "per stirpes" distributions.
- Failure to be clear about whether a particular gift lapses if the beneficiary dies first, or from preventing provincial "anti-lapse" rules from inadvertently resulting in an inappropriate gift over.
- Failure to prevent "trust busting" in certain provinces where there must be a "gift over" in order to defer distribution beyond the age of majority.
- Failure to provide against the rule against perpetuities and the rule against accumulation (applicable in some provinces).
- Failure to ensure the formal requirements for legal documents are present. For example, this includes proper supervision of signing and witnessing in accordance with the formalities under provincial law.
- Failure to ensure that witnesses are not disqualified persons, such as a spouse or beneficiary.

1.13 SUMMARY OF KEY ISSUES

- **The Process:** Estate planning is a process that has a number of essential steps including discovery, analysis, determining objectives, recommendations, implementation, and review. Following the steps in the process ensures that the plan fits the client and reduces errors that may subject the advisor to liability.
- **Tools:** Checklists and forms can be a helpful tool in guiding the client through the process. Whether they are used or not, the advisor should have his or her own protocol that is followed consistently to

be certain that essential information and questions are addressed in the course of the process, and so that no potential problem or issue has escaped scrutiny. For example, is the client or any beneficiary a U.S. citizen? Is there any family member or beneficiary who may need assistance managing an inheritance?

- **Disclosure:** Being disciplined about disclosure is essential to estate planning and clients must understand the importance of providing complete and accurate information. Shortcuts at the disclosure stage can expose the advisor to liability if the plan turns out not to be appropriate because of information that was not communicated or subjected to verification. An astute advisor will be able to ferret out latent issues that the client may be reluctant to disclose but that may be very relevant to the estate planning objectives.

- **The Advisors:** In the course of the estate planning process, issues will be identified by both the client and the advisor, and the expertise from a number of disciplines may be required. The assistance of appraisers, lawyers, accountants, financial planners, insurance agents, trust company personnel, investment advisors, and legal and tax advisors from other jurisdictions may be required. No one advisor can have all this expertise. Knowing when to include other professionals and co-ordinate their input is an important skill.

- **What if's:** A good plan anticipates future events, both anticipated and unexpected. The plan should be tested against the inevitability of change, and modified to ensure it will achieve the client's objectives in all circumstances that can reasonably be anticipated.

- **Follow Up and Review:** No plan is so good it never needs review. Changes may take place over time, or suddenly without warning. A client's family situation, wealth and objectives are never static. Changes in the law can also affect an estate plan. In addition with the passage of time, the persons who might be appropriate executors often change. Clients should be advised that their plan should be reviewed at least every 3 to 5 years or when there is a significant change in their circumstances.

1.14 TERMINOLOGY

Hard Facts: Facts relating to a client's personal and financial affairs that are objective and can be verified with documentation or third parties. A client's date of birth or the value of the cottage property are hard facts.

Hotchpot: An adjustment clause, usually in a Will, that requires the inclusion of the value of other property from outside the estate to be added into the calculation for the purpose of determining the share of a particular beneficiary. For example, if the estate is worth $180,000 and is to be divided equally among three children, the share of each child would be $60,000. But suppose one child has already received insurance proceeds outside the estate of $30,000? A hotchpot clause in the Will requires the insurance to be brought into hotchpot in respect of that child's share and will result in that child receiving only $40,000 from the estate and the other children receiving $70,000 each. This has the effect of equalizing each child's benefit arising on death since each child will have received a total of $70,000, whether from inside or outside the estate passing under the Will.

Per Capita: A distribution that is equal per person no matter what the relationship to the deceased.

Soft Facts: Information relating to a client's views, judgments, wants, and philosophy that are subjective to the client. The fact that a client is concerned about the potential claim of a difficult son-in-law, for example, is a "soft fact." Soft facts often influence a client's objectives.

REVIEW QUESTIONS AND ANSWERS

Questions

1. List four benefits of the estate planning process.

2. Joseph likes to meet with his clients "cold" without requesting his clients provide any information or do any preparation in advance of the initial meeting to discuss estate planning. He believes this permits him to see the bigger picture at the initial meeting without getting bogged down in details about assets and specific information regarding family members. Discuss the advantages and disadvantages of such an approach. What are the advantages of having disclosure at the initial meeting?

3. Which of the following are hard facts:

   (a) Title to the property inherited from the client's parents was left to all the children.

   (b) The client's charitable intentions.

   (c) The number of grandchildren the client thinks are worthy of special mention in his Will.

   (d) The adjusted cost base of shares of a private company.

   (e) The client's concern about her husband's ability to make sound investment decisions.

4. Peter and Paul are married, same-sex partners with one adopted child. They want their estates to go to each other initially, and then to their adopted daughter Tracey, age 21. If Tracey has died, they want their estate to pass to Tracey's children, if any. Peter, who is 62 and a successful professional, has assets worth approximately $4.2 million. Paul, who is 44, is a golf professional with assets worth approximately $335,000. These figures do not include their home, which is jointly held, or their registered plans or insurance for which they have named each other as beneficiaries. What additional information do you need to advise them regarding their estate plan?

5. Assume you are a lawyer or other advisor to Jennifer and Brian, a married couple in their early 50s with two children in university. They are about to live out their lifelong dream of sailing around the world. They are leaving in 10 days to fly to the Caribbean where they will join a group that has chartered a sailing vessel for a round the world adventure. They have rented their home for the next year and taken leaves of absence from their jobs, and used part of an inheritance from Jennifer's aunt to finance their expenses. They have never done Wills or Powers of Attorney before, despite your past advice that these be done. Today is Thursday and Jennifer has just called you requesting that you arrange to have "simple his and hers" Wills and Powers of Attorney prepared for them based on your knowledge of their personal and financial affairs. They can "drop by your office" on the way downtown to pick up their new passports and would like you to have the documents ready next Tuesday for signature. Comment on this situation in the light of the estate planning process, and make recommendations as to how to proceed.

Answers

1. There are many benefits to the estate planning process. You should be able to elaborate on the details of the benefits, explaining how the process results in the benefits. For the purposes of this question, which just asks for a list, you could include:

   (a) ensures the plan fits the client;

   (b) helps uncover issues and opportunities the client may not have been aware of;

   (c) helps prevent errors;

   (d) helps ensure the client is properly insured;

   (e) protects the advisor against liability; or

   (f) provides an opportunity to evaluate the client's capacity.

2. Joseph's approach has the following disadvantages:

   (a) The information needed will still have to be gathered. If gathered at the initial meeting this may result in a tedious discussion over

details. If gathered after the meeting, the "big picture" discussed at the initial meeting may need to be significantly revised. This may make Joseph's job more difficult, as he may have to re-explain the planning strategies appropriate, and clients may become confused or uncertain with respect to his advice. In addition he may have spent some time covering areas that turn out not to be appropriate possibly increasing the cost to the client.

(b) Another meeting may be required to take instructions at which the client's information is reviewed and verified. Having the client provide the details later without review can lead to errors or omissions.

(c) The client can state the objectives at an initial meeting, but objectives must always be analyzed in the light of the client's particular circumstances so the advisor's ability to comment is limited.

(d) Planning opportunities can only be identified in a general way without complete information.

The advantage of Joseph's approach is that it may help overcome client procrastination or reluctance to commence the estate planning process. It is often difficult to motivate clients to do estate planning, and requiring the production of detailed information can be a barrier to overcoming the natural inertia to the process. Having an "introductory" meeting without disclosure may help clients understand what is involved in the process and help motivate them to provide the information required. It may also be appropriate if there is an urgent situation such as where a client has a sudden medical emergency, or is terminally ill. The advisor can probe for capacity at the outset, and determine if it is even possible to take instructions. Disclosure can follow the initial meeting where necessary, but advisors should be extremely cautious if there is urgency — the temptation to "skip full disclosure" because of the circumstances can lead to errors and potential liability. In addition, if the advisor is not able to act immediately, it is better to let another advisor do the estate planning as delay could also result in liability if the client dies before completion.

There are advantages of having detailed disclosure at the initial meeting.

(a) A review of the information gathered at the initial meeting can be done relatively expeditiously with experience. The advisor can verify

details with the client, and creating a "shopping list" of missing information for the client to provide later.

(b) The advisor can make a good assessment of the client's objectives.

(c) The advisor will be able to identify issues and planning strategies that fit the client's situation.

(d) Specific planning opportunities can be identified at the initial meeting.

3. a and d are hard facts.

4. Additional information that may be particularly relevant may include that listed below.

(a) Are there any other family members that need to be provided for? For example, have either Peter or Paul had previous partners or children from other relationships?

(b) Are they married or common law? This is necessary to determine what property regime applies to them under provincial law and the degree of testamentary freedom.

(c) If Tracey has died, at what age should her children receive their inheritance?

(d) How do they want their estates distributed in the event of a common disaster — i.e., none of Peter, Paul, Tracey or her issue survive?

(e) Paul is 18 years older than Peter. Does Peter want to give everything to Paul outright, or does he want to ensure capital protection for Tracey and her issue in the event Peter enters into another relationship and changes his estate plan, or becomes obligated legally to another partner?

(f) What debts do they have? We are only given values of assets not the net value of their estates.

(g) If something happens to either Peter or Paul, will the survivor have enough to pay debts, and continue his lifestyle? (It seems quite likely

given the numbers — but if assets are matched with debt, insurance needs can be identified.)

(h) What is the value of their home? Is it subject to a matrimonial property regime? Is it held jointly as tenants in common or with a right of survivorship?

(i) What is their intention with respect to the home?

(j) What is the value of the registered plans and insurance?

(k) What is their philosophy regarding planning — do they want to "keep it simple" or are they interested in investigating complex planning strategies?

5. The estate planning process requires time that these circumstances do not permit. The advisor should consider carefully whether to get involved at all, given the time pressure and the margin for error. If the advisor knows the clients well, and has up-to-date financial and personal information it may be possible to advance the process far enough before they leave, but this is always a judgement call. Lawyers will generally not prepare Wills or Powers of Attorney without meeting with the client to take instructions. In rare circumstances where this is not possible, the lawyer will have an obligation to meet with the clients before the documents are signed to confirm the instructions, and test for capacity and absence of undue influence and fraud. For example, in this situation, you have only spoken with Jennifer — what are Brian's instructions? These must be verified and any requirements regarding joint retainers for making Wills complied with. If the disclosure can be brought up to date, it may be possible to arrange a meeting with a lawyer before they leave. Any outstanding items can be checked by another friend or family member, after the initial meeting. It is unlikely that all the steps can be concluded in such a short time. There needs to be a face-to-face meeting with the lawyer preparing the documents. Disclosure needs to be completed as fully as possible. The documents must be prepared, and the clients should review the drafts so that changes can be made if required. With modern communication, it may be possible to take instructions before they leave, and have draft documents sent by email, fax, or other means. Final documents might be emailed with instructions regarding due execution, or even sent by mail, to a lawyer in another jurisdiction on their

itinerary, or directly to the client. If simple "his and hers" Wills and Powers of Attorney are really all they need, it may be possible to complete the documents before they leave. However, caution is necessary. Haste always involves risk of overlooking something and making mistakes. Even with simple "his and hers" documents, Jennifer and Brian must still choose their executors and determine how their children will receive the inheritance.

STUDY UNIT TWO

PERSONAL ESTATE PLANNING

Knowledge Objectives

Skills Objectives

Topics Covered

Related Textbook Readings

2.1 INTRODUCTION 2-7

2.2 CHARITABLE GIVING 2-7

2.2 .1 Case Studies for Charitable Giving 2-10

2.3 CREDITOR PROTECTION 2-12

2.4 PLANNING FOR INCAPACITY 2-14

2.5 PROBATE FEE PLANNING 2-15

2.5.1 Case Studies in Probate Fee Planning 2-16

2.6 WILL PLANNING 2-19

2.7 TAXATION AT DEATH 2-22

2.7.1 Case Studies for Taxation at Death 2-26

2.8 PLANNING WITH TRUSTS 2-26

2.8.1 Case Studies on Trusts 2-29

2.9 SUMMARY OF KEY ISSUES 2-31

2.10 TERMINOLOGY 2-32

REVIEW QUESTIONS AND ANSWERS 2-34

Study Unit Two

Personal Estate Planning

Learning Objectives

Knowledge Objectives

Upon completion of this unit the student will:

- Know how trusts are utilized to achieve non-tax objectives
- Understand how trusts are used in tax planning
- Understand the role of tax and estate planning in preserving and transferring wealth
- Understand post-mortem tax planning strategies and when they are appropriate
- Understand complex tax issues and traps applicable to trusts and estates
- Know how to plan for incapacity and death
- Understand the tax and legal consequences of death
- Understand how provincial succession laws can impact estate plans
- Understand the rules relating to charitable giving

Skills Objectives

Upon completion the student will, in relation to the topics listed below, be able to:

Planning with Trusts

- Analyze the client's current financial status and financial planning objectives with a view to determining a planning strategy involving the use of trusts
- Examine alternative types of trusts that may apply to support the client's estate planning strategies
- Illustrate to the client the benefits of the use of trusts in estate planning
- Know how trusts are utilized to achieve non-tax objectives
- Understand how trusts are used in tax planning
- Understand complex tax issues and traps applicable to trusts and estates

Trusts for Non-Tax Reasons

- Describe the ways trusts can be used to preserve wealth and provide protection
- Identify how trusts can be used to achieve non-tax objectives
- Take into account advanced tax issues and traps for trusts and estates
- Explain the potential problems arising from the attribution rules and the 21-year rule
- Identify key tax problems often encountered with trusts and estates

Charitable Giving

- Identify the client's charitable giving objectives and discuss alternatives for planned giving during life and at death
- Understand the rules relating to charitable giving
- Identify how charitable giving can be incorporated effectively into an estate plan

Creditor Protection

- Identify any current or potential creditor issues and discuss alternative strategies for the preservation of assets

Planning for Incapacity

- Identify the need for planning for incapacity
- Describe how Powers of Attorney are used in the event of incapacity
- Identify the criteria for choosing a substitute decision maker
- Compare the advantages and disadvantages of selecting particular substitute decision makers and explain the alternatives to the client
- Assess the client's Powers of Attorney
- Assess the client's health care directives or personal directives
- Understand some of the obligations of attorneys and agents

Probate Planning

- Examine alternative strategies for the efficient and secure transfer of assets inside and outside the Will at death
- Show the client alternative strategies and assist him/her in selecting the most appropriate strategy for his/her situation

Will Planning

- Assess the role of a Will as critical to true estate planning, whether one views that planning as being aimed at the fulfillment of the deceased's desires relating to estate distribution or tax minimization
- Explain the benefits of engaging a qualified lawyer to develop a reliable Will
- Compare the advantages and disadvantages of various choices for executor and explain the alternatives to the client
- Assess the client's estate liquidity and explain the issues around an estate that does and does not have liquid assets

Estate Tax Planning

- Formulate appropriate estate planning strategies to mitigate the effect of the tax implications at death
- Identify post-mortem tax planning opportunities
- Describe the strategies for post-mortem planning with closely held corporations, including reducing the double tax on property held in a corporation
- Analyze the client's assets and ownership interests and determine those properties that will and will not be subject to probate
- Explain how rollovers and the capital gains exemption can be advantageous

Topics Covered

Uses of Trusts for Non-Tax Reasons

- Protect Individuals from Themselves or Others
- Preserve Provincial Disability Benefits
- Preserve Capital for Another Beneficiary
- Defer Ownership Decisions
- Motivate Behaviour
- Alternatives to Powers of Attorney
- Probate Avoidance
- Confidentiality
- Preserve Particular Assets
- Asset Management
- *Inter Vivos* and Testamentary Trusts

Uses of Trusts for Tax Planning

- Testamentary Trusts
- Trusts as Shareholder
- Distribute Dividends to Low Rate Beneficiaries

Charitable Giving

- Identifying Charitable Objectives
- Rules re: the Donation Tax Credit
- Structuring Philanthropy

Creditor Protection

- Creditor Protection for Insurance and Registered Plans

Incapacity Planning

- Powers of Attorney for Property
- Health Care Directives and Personal Directives
- Choosing a Substitute Decision Maker

Probate Planning

- Assets in Joint Title
- Naming Beneficiaries
- Separate Wills for Non-Probate Assets
- Alter Ego Trusts and Joint Spousal/Partner Trusts

Wills and Intestacy

- Importance of Having a Will
- Contents and Legal Effect of a Will
- Choosing an Executor
- *Per Capita* and P*er Stirpes* Distributions
- Distribution of Assets on Death through the Estate and Outside the Estate
- Simultaneous Deaths
- Consequences of Intestacy

Estate Tax Planning

- Tax Planning Strategies to Defer or Minimize Tax on Death
- Taxation on Death
- Post-Mortem Tax Planning

Related Textbook Readings

Estate Planning with Life Insurance
Glenn R. Stephens, LL.B.

Chapter 3	Life Insurance and the Need for Estate Liquidity
Chapter 7	Using Legal Documents as Sales Tools; What to Look for in Shareholders Agreements and Wills
Chapter 9	Charitable Giving Strategies Using Life Insurance
Chapter 10	Life Insurance and Trusts
Chapter 11	Creditor Protection

Wealth Planning Strategies for Canadians
Christine Van Cauwenberghe, B.Comm. (Hons), LL.B., CFP, TEP

Chapter 18	Powers of Attorney
Chapter 19	Estates
Chapter 20	Personal Representatives
Chapter 21	Taxation at Death
Chapter 22	Probate
Chapter 23	Trusts
Chapter 24	Charitable Giving

2.1 INTRODUCTION

Preserving wealth and implementing an effective plan for wealth transfer are at the heart of personal estate planning. The stages of wealth management are wealth creation, wealth preservation, and wealth transfer.

At the first stage, wealth creation, an individual builds wealth during lifetime. This can occur through employment, practicing a profession, or carrying on a business, to identify the most common sources of wealth. This stage is sometimes referred to as "body at work." The phrase may be a misnomer if the source of wealth is from inheritance or other windfall such as lottery winnings.

The next stage, wealth preservation, often referred to as "money at work," describes the management and preservation of wealth during lifetime. Wealth may be invested in real estate, the stock market, or in a business venture. At this stage the individual may be approaching or enjoying retirement.

The last stage, wealth transfer, often starts during lifetime and overlaps the wealth preservation stage. Charitable giving and transfers to trusts or family members often commence during lifetime. The wealth transfer process has its final stage at death, when the property amassed during lifetime is transferred to a new owner. The actual transfer of property may be extended many years beyond the death of the individual by various means, including trusts and charitable foundations.

Personal estate planning, including trust planning, tax planning, and planning for incapacity, occurs as part of the last two stages of wealth management — wealth preservation and wealth transfer.

2.2 CHARITABLE GIVING

Working with clients to identify and implement philanthropic objectives requires an understanding of what motivates people to make donations to charitable causes. The tax benefits may be attractive, but there must be a true desire to benefit the charity as the tax benefits cover only a portion of the cost. When taking Will instructions, the client may not be thinking about donations, but often will decide to include donations when this topic is explored with the advisor. Here are some questions to help identify charitable intent and uncover tax motivated giving:

- Are there any causes you support or would like to support?
- Do you support your church, synagogue, place of worship, etc?
- In your annual income tax returns, do you claim any charitable donation credits?
- Would you like to make one last gift as a parting legacy to the charities you've supported during your lifetime?
- Are you aware of the tax benefits of charitable giving?
- Are you aware of the special tax benefits of donating publicly traded shares with unrealized capital gains to charity?
- Are you interested in learning how insurance can be used to fund charitable giving without significantly reducing your family's inheritance?

Clients may have a desire to make donations subject to conditions. This can cause problems. The condition may not be enforceable for any number of reasons. For example, the condition may be void for uncertainty, or contrary to public policy. The condition may not be consistent with the charity's objectives, or may no longer be appropriate at the time of death. A gift to the church to "replace the roof" may not be appropriate if this has already been replaced when the testator dies. The advisor will need to work with the client to ensure not only that the client's objectives can be implemented, but that the charity will also accept the gift. Contact the charity directly to design the terms of a gift to suit the charity and the donor.

Consider the benefit of community foundations where the client has specific charitable purposes, but the creation of a charitable foundation is not feasible because the gift is modest, or the client has no desire to bear the cost or the administrative burden of operating a charity. For example, a $40,000 gift for scholarships to needy students who are recent immigrants to Canada could be made to a community foundation in the memory of the testator. Community foundations permit "donor directed" gifts, and the testator can name a person who would assist the community foundation to select the recipients of the funds. A number of Canadian financial institutions also offer donor advised funds.

The wrong name of the charity in the Will or trust is often the subject of litigation or a failed gift. The Canadian Association of Gift Planners ("CAGP") publishes the

Canadian Donor's Guide, which lists many of the Canadian registered charities. It is published annually and distributed to all lawyers in Canada who are members of the Wills, Estates and Trust section of the provincial chapter of the Canadian Bar Association. It can also be purchased directly and viewed on the CAGP website. Canada Revenue Agency (CRA) also lists all registered Canadian charities on its website. If the organization is not on this list, a donation tax credit will not be available.

There are a number of ways charitable donations can be structured. The appropriate strategy will depend on many factors, including the donor's particular intentions or wishes, the donor's assets, the tax treatment, the size of the gift, the requirement for flexibility during lifetime, and whether the donor is insurable. The two course texts discuss these strategies in some detail along with the benefits and tax consequences of each, which include the following:

- direct donation of cash to a charity,
- donation of property in kind,
- donation of an insurance policy,
- naming a charity as a beneficiary of a life insurance policy,
- naming a charity as the beneficiary of an RRSP or RRIF,
- donating to a charitable remainder trust,
- donating to a private or public charitable foundation,
- donating to a donor advised fund, and
- structuring a donation through an annuity, insured or otherwise.

The tax treatment of a donation of capital property in kind, or *in specie*, results in a deemed disposition at fair market value for tax purposes. If there is an unrealized gain, the donation will result in a capital gain, 50% of which must be included in the donor's income, subject to a "zero" inclusion rate for publicly traded securities and certain other very specific types of property, such as ecologically sensitive land. However, for donations to registered charities, the *Income Tax Act* permits the donor to elect the proceeds of disposition for tax purposes (not to exceed the fair market value), in which case the donation amount will be equal to the amount of the election. Insurance policies are not capital property and the treatment of their donation is discussed in the course texts.

2.2 .1 Case Studies for Charitable Giving

Wealth Planning text at 24.2.7 – Annuities and 24.6.2 – Using Insurance to Fund a Charitable Gift
In section 24.6.2, insurance is used to provide funds to cover the tax liability and make a charitable donation.

Jack may be unsure his beneficiaries want to use and maintain the cottage after his death. While Jack may think his family shares his emotional attachment to the property, often children or grandchildren may not want to use a recreational property if it means they are required to maintain it as owners, and they may prefer cash instead. The benefit of this plan is that the tax on the cottage is funded thereby providing additional assets in the estate to be distributed to the beneficiaries. This may make keeping the cottage more attractive to Jack's beneficiaries. It reduces the asset-rich, cash-poor problem of estate liquidity and the insurance works well to achieve both of Jack's estate planning objectives.

Consider the requirements in order for this plan to be effective.

- There must be tax payable on Jack's death in order for the donation credit to be utilized.
- The donation credit will reduce tax on death, but the cost of the donation is greater than the value of the credit. It is the combined objectives of passing the cottage to beneficiaries in kind and the desire to make a charitable donation that recommends this plan. Jack should make sure his beneficiaries intend to hold the cottage after his death.
- Jack's Will must be amended to include the donation in order for a donation credit to be available on death and the beneficiary of the insurance must be the estate in the facts as given.
- It will be important to consider the amount of the donation and how it is to be calculated. Will it be the full amount of the insurance or a smaller portion? Will it be a fixed amount, or calculated by reference to a formula that refers to the tax liability? The amount cannot be left to the absolute discretion of the executors, and if a range is permitted, only the minimum amount will qualify for the donation credit. Tax advice may be required to ensure the method of calculation does not disqualify the gift for the donation tax credit.

- Naming the estate as the beneficiary of the insurance will expose the insurance proceeds to the claims of creditors and probate fees. There may be ways to designate both the charity and family members as beneficiaries in a separate part of the Will to keep the insurance proceeds separate from the estate. However, the *Carlisle* decision from Saskatchewan has made the success of this strategy more challenging and legal advice must be obtained. Jack may want to consider ways to use an insurance trust to achieve his objectives to save probate fees and protect the insurance from creditors.

- If Jack is married, there will be no tax liability in respect of the cottage if his spouse is beneficiary because of the spousal rollover. One option would be to elect out of the spousal rollover and use the donation credit to offset the tax liability and pass the cottage to the surviving spouse with a tax cost that is based on the fair market value on Jack's death. However, prepaying a tax liability usually is considered poor tax planning, and Jack may consider alternative strategies that defer the tax liability until the death of his spouse and defer the timing of the donation credit until that tax liability occurs.

- The gain on the cottage can be deferred until the death of his spouse, assuming that his spouse will inherit the cottage and that the gift will be made to other beneficiaries only after the last to die of Jack and his spouse. In that case, the insurance could be joint last to die, reducing the cost of the policy. The Wills of both Jack and his spouse must reflect the donation and the beneficiary designation should be for the estate of the survivor of Jack and his spouse.

- If a spousal trust is used for the cottage the tax planning for the donation credit becomes much more complex. Where there is an intervening life interest, such as a trust, and the donation is made after the life tenant (in this case the surviving spouse) dies, no donation credit will be available on the death of the life tenant.

- If the trust qualifies as a charitable remainder trust, and/or there is no right to encroach on capital for the benefit of the life tenant, the donation credit would be available on Jack's death in an amount equal to the present value of the donation at the time of death. This does not match the timing of the tax liability that will occur on the

death of Jack's spouse, assuming the spousal rollover to the spousal trust is used on Jack's death.

- If the trust is not a charitable remainder trust, and/or there is a right to encroach on capital, a donation credit may be available only if there is a permitted degree of discretion with respect to the donation. Otherwise the donation will be considered a distribution of capital or income in satisfaction of a capital or income interest in the trust or estate and not a charitable gift. The degree of discretion required to satisfy CRA's administrative requirements for the donation credit to be available to the estate or trust after an intervening life interest may be inconsistent with Jack's intentions. For example, providing discretion to the executors as to whether or not to make a gift to charity will satisfy CRA's requirements but not Jack's wishes.

Life Insurance text at Chapter 9 at 9.2(b)(i) Personally Owned Policy with Charity as Beneficiary
In this example, Janet uses life insurance to fund a charitable donation that creates a donation tax credit to offset the tax on a capital gain on death.

Life Insurance text at Chapter 9 at 9.3(d) Insured Redemption of Shares to Benefit Charity
In this example, corporate-owned life insurance is used to fund a redemption of shares on death, the proceeds of which are used to benefit a charity of the shareholder's choice.

Life Insurance text at Chapter 9 at 9.4(b) Gifting of Public Shares Owned by Private Corporation: Impact on Capital Dividend Account and at 4(c) Life Insurance Opportunities
A corporate donation of publicly traded shares attracts no taxable capital gain in the corporation, but is added to the CDA. Life insurance can be used to replace the value of the corporation for the donated shares.

Life Insurance text at Chapter 9 at 9.5(e)(i) – Donating Using Income from Prescribed Annuities
Using a prescribed annuity to fund ongoing charitable donations.

2.3 CREDITOR PROTECTION

Any aspect of estate planning should take creditor protection into account. Unfunded liability can arise from unexpected sources beyond poor money management and over spending. Negligence claims, motor vehicle accident claims in excess of insurance limits, or other events can result in financial failure. Income tax reassessments or unpaid taxes may be an issue. If an individual is a

sole proprietor or general partner in a business or profession, he or she may be exposed to creditors of the business or partnership. Many financial institutions or other business lenders may require personal guarantees by the shareholders or other family members as a condition of corporate lending. Family members may also sue an estate under family law (in the case of a spouse) or under dependants' relief legislation where arrangements for adequate support have not been made. Any of these can expose the assets of an individual to claims upon death.

This is a complex area of law. Conveyances, settlements, or transfers of property that are designed to defeat creditors or prefer one creditor over another at a time when the transferor is insolvent or subsequently becomes insolvent (i.e., unable to pay liabilities as they fall due) may be considered fraudulent and set aside under provincial law, or under federal bankruptcy law. It is not the purpose of this course to cover specific "creditor proofing" planning. The purpose here is to ensure that the advisor can identify the situations where personal financial and estate planning can be arranged to preserve capital and estate assets from claims of creditors.

A number of strategies are available to provide some protection from creditors.

- **Asset Protection Trusts:** These trusts isolate the property of an individual in a trust that is not controlled by the settlor. The terms of an asset protection trust must be carefully drawn to provide the appropriate protection from creditors and there is always a balance between access and control on the one hand, and the degree of creditor protection provided on the other. Many asset protection trusts are settled in offshore jurisdictions where laws relating to setting aside transactions designed to defeat creditors are more debtor friendly and/or collection by creditors is more difficult. The use of asset protection trusts is beyond the scope of this course.

- **Use of Life Insurance – on Death:** Under provincial law the death benefit of a life insurance policy paid to a named beneficiary is not part of the estate of the life insured and is protected from creditors. This assumes that the "named beneficiary" is not the estate.

- **Use of Life Insurance – During Lifetime:** A life insurance policy will be exempt from seizure by creditors if a spouse, child, grandchild, or parent of the life insured is named as a beneficiary. Details may vary by province. In Quebec, creditor protection is based on the

relationship between the policy holder (not the life insured) and the beneficiary.

- **Registered Plans on Death (RRSPs and RRIFs):** Where there is a named beneficiary, proceeds of a non-insurance product RRSP or RRIF are exempt from creditors of the deceased annuitant as a result of the Ontario Court of Appeal decision in *Amherst Crane*. This case may have application across Canada. Where the plan is invested in an insurance product, the proceeds will be exempt from claims of creditors on the same basis as life insurance proceeds, i.e., if paid to a named beneficiary.
- **Registered Plans – In the Event of Bankruptcy (RRSPs and RRIFs):** Bankruptcy is a federal matter, and the registered plan of a bankrupt annuitant will not be subject to the claims of creditors, subject to a few exceptions (e.g., contributions made to the plan in the 12 months prior to the bankruptcy are not protected).

2.4 PLANNING FOR INCAPACITY

Canadians are living longer, and the number of seniors who are unable to make decisions for themselves is greater than ever. The law relating to substitute decision making, including powers of attorney and guardianship is becoming very important in modern day practice. Unfortunately the estates of incapable persons are often the subject of litigation, usually where attorneys or guardians have not carried out their responsibilities with diligence and honesty. Mismanagement by an attorney is often not discovered until the donor dies, and by that time considerable loss may have occurred and it may be too late to enforce any remedies against the attorney. Good planning can assist to some extent, although choosing an attorney who has the right qualities may go a long way to avoiding abuses. Not only must the attorney be honest and a good money manager, he or she must be willing and able to carry out their responsibilities diligently and continuously.

The law relating to substitute decision making for personal and health care varies considerably by province. If there is a power of attorney for personal care or a health care directive in place, most jurisdictions in Canada require the attorney or agent (or whatever the name for such person is in the particular province) to consent to medical treatment if the patient is unable to provide such consent.

2.5 PROBATE FEE PLANNING

Probate fees are quite low in Alberta, Nunavut, Northwest Territories, Quebec and the Yukon. In these jurisdictions, probate fees are truly "fees" in that the modest cost of obtaining the grant of probate reflects the service provided. However, in the other provinces higher rates of probate fees apply, such that in legal terms the fees are actually a tax. For example, in Ontario the cost of probate is called the Estate Administration Tax. The difference between a fee and a tax became key when the Supreme Court of Canada in *Eurig* confirmed that the Ontario probate "fees" were unconstitutional because they were a tax not a fee, and as such had to be imposed by statute not by regulation. While the Eurig estate escaped the tax, the Ontario government was permitted to retroactively amend the legislation to protect its right to collect the tax. For convenience, the term "probate fee" will be used generically here except where the context dictates otherwise.

In jurisdictions where probate fees are really a tax, probate fee planning may be relevant to reduce the cost of obtaining the grant. However, probate fees are only above 1% in British Columbia, Ontario and Nova Scotia, so even in the "high" rate provinces the amount is still very low, particularly in comparison to income tax rates. Probate fee planning should never be done in isolation, as failure to understand the potential consequences of steps taken to reduce the cost of probate can result in disaster. The problems are numerous, but generally fall into two categories – failure to distribute the assets of the deceased among beneficiaries in the way that was intended, and increased income tax liability or missed income tax planning opportunities. In addition, many lawsuits have resulted from using joint accounts were there is uncertainty as to the intention of the deceased. Like all estate planning the assistance of a professional is advised, and no estate planning strategies should be implemented without reviewing the overall plan to make sure there is consistency.

Unfortunately probate fee planning is an area where clients often wilfully engage in destructive self-help. The strategies to reduce probate fees often have a significant impact on the distribution of wealth on death. For example:

- If a large portion of the assets of the deceased are passing outside the estate to avoid probate, it can be difficult, and sometimes impossible to achieve estate equalization through the Will even with good planning. The use of a hotchpot clause in a Will is sometimes used to provide for an adjustment to the share of a beneficiary to

account for property passing outside the estate. However, there must be sufficient assets in the estate to fund the adjustment.

- There is no gift over for assets passing outside the Will. A “gift over” is a provision that provides for an alternate beneficiary in the event the primary beneficiary has died first. Limited gifts over, or “contingent beneficiaries,” can be made in beneficiary designations for insurance or registered plans, but financial institutions will accept only the most simple gifts over. It is not possible to provide for a gift over for jointly held property. Complex gift over provisions are standard in any professionally prepared Will. The most common gifts over are to the children of the deceased if the spouse has died first, and to the grandchildren of any child who has pre-deceased the testator. See the discussion on the case study below, under *Wealth Planning* text at 22.3.1.3 – Unintentional Unequal Treatment of Beneficiaries, for an illustration of problems with jointly held property where there is an “out of order” death.

One less problematic approach may be to use a “multiple will” strategy where a second will governs assets that can be transferred without a grant of probate (e.g., shares of a privately held corporation). The courts in Ontario and British Columbia have confirmed the validity of this strategy. The availability of this strategy in other provinces is uncertain and as yet untested by the courts, and depends on the particular language of the statute that imposes the fee, although it is clear that they cannot be used in Nova Scotia.

Another potential probate strategy may be to create an *alter ego* trust or joint spousal/partner trusts. Although the instances in which these types of trusts may be limited, they can be useful in certain situations. See section 22.3.5 of the *Wealth Planning* text for more information on when these types of trusts may be helpful. Insurance trusts may also assist in reducing probate fees on insurance proceeds, but again, only if properly structured. See section 22.3.7 of the *Wealth Planning* text for more information on these types of trusts.

2.5.1 Case Studies in Probate Fee Planning

In Chapter 22 of the *Wealth Planning* text, Murray is trying in various inappropriate ways to avoid probate fees on a vacation property on which he is not claiming the principal residence exemption. The perils of probate fee planning gone bad

are well illustrated in these case studies which are by no means a complete set of potential problems, although they cover the most common errors. All the case studies in Chapter 22 should be reviewed.

Wealth Planning text at 22.3.1.1 – Triggering Capital Gains Tax

Here Murray has transferred the property into joint names with his daughter, Josee, in a "true gift." What is the evidence of the true gift? If Murray's intention was not properly documented (i.e., Josee relies on oral statements of intention, or the written evidence is vague, inconsistent or ambiguous), there could be litigation over whether the property is still an asset of the estate. For example, assume that Ron and Josee, Murray's two children, share the residue of Murray's estate equally under his Will. Ron might challenge the true nature of the gift to Josee if he wants to increase his inheritance. Proper documentation to rebut the presumption of resulting trust when there is a gratuitous transfer to someone other than a spouse is essential.

In this case study, the principal residence exemption is not relevant – but what if the property were Murray's only residence? Transfer to Josee would be sheltered by the principal residence exemption, but on a subsequent sale, in order to shelter the full gain, both Murray and Josee would have to claim their principal residence exemption. This would potentially be a disadvantage to Josee if she has another residence that qualifies during the years of co-ownership. The remedy might be to put the title into joint names without there being a true gift although there are many problems, including whether CRA would recognize the documentation relating to the absence of a gift, and in the event Murray's estate required probate because of other assets, the value of the property would have to be included and would be subject to probate fees in any event.

Wealth Planning text at 22.3.1.3 – Unintentional Unequal Treatment of Beneficiaries

Here Murray has put the property in joint names with a right of survivorship with his two children, Josee and Ron (as "true joint owners"). Ron dies before Murray leaving two surviving children whose inheritance does not reflect the value of the vacation property that passed to Josee. If there were a hotchpot clause in Murray's Will that called for an adjustment to Josee's share to take into account her receipt of the vacation property, then Ron's surviving children's share could be equalized with that of Josee after taking into account property passing through the estate and outside the estate.

Note that in drafting the hotchpot clause the lawyer should inquire with respect to jointly held property as to what proportion of the value of the property should be taken into account. Presumably Murray would want the entire value of the property to be taken into account in calculating the adjustment, assuming his intention is that each of his children's families should share the entire value of the property equally.

For example, assume Murray's estate after taxes was worth $700,000. With no hotchpot, Josee would get half the estate ($350,000) plus the vacation property ($500,000) for a total of $850,000. If the hotchpot clause required the entire value of the vacation property to be "taken into hotchpot" in calculating Josee's share, the entire value of the property is added to the estate to determine the share of each beneficiary and make the appropriate adjustment to the share of the estate. Adding the estate and the property together results in a total of $1,200,000 ($700,000 + $500,000), half of which, or $600,000 is Josee's share. Since Josee already has $500,000 by way of the vacation property, she is only entitled to another $100,000 from the estate leaving $600,000 that would have been Ron's share, to be subject to the gift over to his two children.

In the event the net value of Murray's estate is worth less than the value of the property transferred to Josee – $500,000 – Ron's children's share of the estate would be insufficient to provide an equal share to them and the hotchpot clause would have been only partially effective.

Wealth Planning text at 22.3.1.5 – Tax Liability for Estate

Here Murray forgot to take into account the tax that would be payable on death on his remaining share of the vacation property. He assumed that a fair distribution would take place by giving the vacation property to Josee by virtue of joint ownership, and making Ron the sole beneficiary of his estate. However, since there is a deemed disposition of Murray's remaining half interest in the property for tax purposes on death, Ron's inheritance is reduced by the tax payable on the capital gain. A similar inappropriate result would occur if Josee were made the beneficiary of Murray's RRIF. The tax on the registered plan would not be withheld from the payment to Josee, and the tax liability is a liability of the estate as the proceeds are included as income in Murray's final income tax return.

2.6 WILL PLANNING

It is critical that advisors be able to explain the need for an up-to-date Will prepared by a lawyer who has the appropriate expertise for the client's particular needs. The fallout from poor planning and an inadequate Will does not usually occur until the testator (or intestate) is incapable or dead. Individuals who have had a family member pass away without a good estate plan, or no Will at all, are often anxious to ensure their own estate plan is well prepared because they have lived through the problems that can occur. Consequences of poor planning or no planning include inappropriate distribution, emotional strife, family conflict, litigation, family law claims, dependants' relief claims, delays, additional costs, wasting of assets while no person has authority to manage the assets of the estate or family members cannot agree, inadequate provision for spouse and dependants, problems with minor beneficiaries, additional income tax liability, etc. These are discussed in detail in the *Wealth Planning* text.

Often individuals will procrastinate about preparing Wills and powers of attorney until there is a perceived need or crisis. The following factors can be good motivators:

- illness,
- surgery,
- travel,
- death of a loved one or sudden death of an acquaintance,
- birth in the family,
- marriage, particularly second marriage,
- urging of spouse, or
- world events, such as 9/11.

The cost of doing a Will is a barrier for many individuals who may have used a lawyer only when they purchased a home and not otherwise. However, if one compares the cost of making a Will with the annual cost of the insurance policy on one's home and car, the one-time fee for preparing a Will to ensure that the entire wealth accumulated during lifetime is properly transferred without the provincial and federal government maximizing their share may be seen from

a better perspective. Most lawyers will prepare Wills. However, not all lawyers have the expertise that may be required for particular situations. Tax planning, trust planning, planning for owner-managers, problem beneficiaries, conflicts of interest, and history of family dissention may all call for a lawyer whose practice includes estate planning as a main or significant component.

The choice of executor or personal representative is often not given sufficient thought. The appointment of the surviving spouse and then all the children follows the way most individuals distribute their property on death. However, some probing may reveal weaknesses in this strategy. The following questions might be asked.

- Who should administer the estate if the surviving spouse is 80 or older?
- Do the children always get along?
- Do the children speak to each other and all live in Canada?
- Is there one child who tends to take control and is resented by the other children?
- Are there one or more children whom the others all respect?
- Do the terms of the Will provide for ongoing trusts where discretion is to be exercised? If so, how will the personal representatives exercise that discretion – is there any concern that the children may not agree, or if some are left out, that they may resent the position of the other?
- Will the persons chosen outlive the termination of any trusts?

An impartial person is often a wise choice if there is potential conflict, acting alone or along with other family members. When death occurs in a family, particularly on the death of the last parent, children and their life partners are often very emotionally fragile and life-long resentments that were repressed for the benefit of “keeping the peace for mom and dad” often rise to the surface and spark anger and conflict. Unfortunately parents often over-estimate the degree to which their children will co-operate as co-executors. The appointment of a personal representative who will not enter into this arena of conflict can go a long way to an efficient administration and avoid litigation. Naming three persons and permitting a majority decision can help break deadlocks, and if one person tends

to be the most respected or reasonable, the testator can require that person to be a member of the majority. Wills also can name a person to whom the executors can turn for advice or assistance in making decisions, although the personal representatives are still responsible for making decisions themselves.

It is important for testators to understand the consequences of the administration of the estate being hijacked by warring personal representatives. In general the courts will not come to the assistance of personal representatives who cannot make their own decisions. While it is possible to ask the court for direction, the courts will not remove an executor for failure to agree on a decision (assuming no wrong doing is present) nor will the court substitute its decision for one that the personal representatives have been given the authority to make in the Will. This in effect forces the personal representatives to work together, and can cause further resentments and conflict.

Distribution of an estate from the Will takes place through general gifts, specific gifts, and through the residual clause. General gifts are gifts of cash. Specific gifts are gifts of specifically identified property. Once all debts of the deceased and of the estate are paid, and tax clearance certificate obtained, the remaining property of the estate is available for distribution. Any specific or general gifts are distributed first and the remainder is referred to as a residual gift.

If there is insufficient property to pay all debts, the gifts in the Will must be reduced, and this reduction is called “abatement.” The residue is exhausted first. Then general gifts abate first (after the residue), then specific gifts of personal property (moveable property), then specific gifts of real property.

Where property that is subject to a specific gift in the Will is no longer owned by the testator on death, it is said to “adeem” and the beneficiary will not receive anything in respect of that gift. For this reason testators should be careful when disposing of a large portion of their estate through general and specific gifts as some beneficiaries may be inadvertently short-changed, either through abatement or ademption. In addition, because the value of particular assets can fluctuate, the value of any particular beneficiary’s inheritance is unpredictable and the testator’s intentions may be frustrated. Using the residual clause to dispose of the bulk of the estate is often more appropriate as the property of the testator can be divided into the appropriate portions for each beneficiary from a common pool of assets.

Where the beneficiary of a gift in a Will dies before the testator, the gift is said to "lapse" and the property will fall into the residue of the estate to be disposed of under the residual clause. If the gift subject to lapse is in the residual clause, there will be an intestacy with respect to that property. A gift will not lapse if there is a contrary intention expressed in the Will, such as an alternate gift or gift over of the property to another beneficiary. Use of the words "if she survives me" indicates that the gift will lapse if the individual dies before the testator assuming there is not also a further gift such as, "but if she does not survive me to X, if he survives me" in which case the gift would only lapse if both beneficiaries die before the testator. Most provinces have anti-lapse legislation whereby if a gift to a deceased family member is made in a Will, and the gift would otherwise lapse, there is a statutory gift over to another family member. For example a gift "to my son Tom," may pass under anti-lapse legislation to Tom's children if Tom pre-deceases the testator.

In preparing a Will it is always important to provide for contingencies. What if the personal representative dies or moves away and cannot act? What if a child dies first? What if the estate increases or decreases significantly in value? What if children get divorced? What if the property gifted to a particular beneficiary is sold? While it is always possible to change a Will to fit new circumstances, a good Will anticipates many contingent events so that the Will still provides an appropriate result in the event the Will is not revised, or the testator is no longer capable to make a Will.

2.7 TAXATION AT DEATH

The desire to minimize taxes on death is often a motivator for estate planning. While the consequences of dying without a Will can result in higher taxes, tax planning should not be the only motivator. However, many people avoid the topic of death because it makes them feel uncomfortable and, for these individuals, fear of taxes may be a last resort to overcome the procrastination that often accompanies estate planning.

On death there is a deemed disposition at fair market value of all capital property and all inventory. The funds in all RRSPs and RRIFs are fully taxable as income. The income and capital gains triggered by death are taxed in the terminal return, the tax return of the deceased for the year of death runs from January 1 to the day of death. The income and capital gains included in the year of death may result

in a higher tax bill, and may also result in more taxable income being subject to the top marginal tax rates. There are a number of exceptions to the tax on death:

- the principal residence exemption,
- the spousal rollover for capital property transferred to a spouse or "qualifying spousal trust,"
- the capital gains exemption for shares of a qualified small business corporation,
- the capital gains exemption for qualifying farm property,
- the capital gains exemption for qualified fishing property (including licenses),
- the inter-generational rollover of qualified farm or fishing property,
- the spousal rollover for RRSPs and RRIFs, and
- other restricted rollovers for RRSPs and RRIFs to a financially dependent minor child, financially dependent disabled adult, and a trust for a mentally disabled child or spouse.

One of the most important tax planning objectives is to ensure that the tax liability on death does not interfere with the plan of distribution to beneficiaries. Will there be sufficient assets in the estate to pay the taxes and also pass specific assets to beneficiaries? The family vacation property and family business are common examples of assets that the client may intend to pass on to the next generation, but which may need to be sold in order to pay the tax liability.

Since only one principal residence exemption is available to a married couple (for years after 1981), the family vacation property is often taxable on death of the surviving spouse. If the property has increased significantly in value, and this is often the case where the property has been held for many years, and may have even been passed down from a previous generation, then the high value of the property only increases the tax bill with no additional cash in the estate to pay it. If the assets of the estate are not sufficient to pay the taxes, insurance may be an option.

With a family business, there may be tax relief if the shares qualify for the capital gains exemption. This is a cumulative lifetime exemption available to individuals only. With good planning, business owners may be able to double up on the use

of the exemption with a spouse, and there are also strategies to multiply access to the exemption with other family members by using *inter vivos* trusts.

In addition to the above exemptions, there are a number of elections and special tax rules that can further reduce the impact of taxation on death.

- Capital losses, including unused capital loss carry forwards from previous years, are deductible against any source of income in the year of death, and can be carried back to the year before death to offset any source of income in that year.
- Capital losses in the first taxation year of the estate can be carried back to the terminal return and used to offset any source of income in that year (but there is no further carry back to the prior year).
- Unused RRSP contribution room can be used to make a tax deductible contribution to a spousal plan if made within 60 days from the end of the year of death and can be deducted from the terminal return.
- A separate return is available for income that qualifies as “rights and things” (such as declared but unpaid dividends).
- A separate tax return is available for “stub period” income from a business where the tax year end is not December 31 and the taxpayer dies after the tax year end in the calendar year.

None of charitable donation credits, non-refundable personal credits, capital losses, non-capital losses, or the capital gains exemption of the deceased flow through to the estate or any beneficiary. It is therefore tax efficient to use them fully if possible in the returns of the deceased. The personal representatives can elect out of some of the rollovers available to generate additional income to absorb losses, deductions, or credits, including the deduction available on property eligible for the capital gains exemption. In addition, if there was little or no income in the year of death, triggering income to be taxed at the lower marginal rates may be appropriate.

The benefit of electing out of a rollover on capital property is that the cost base to the beneficiary will be increased from the estate’s cost to the fair market value thereby sheltering additional capital gains when the property is sold by the spouse. In the case of the spousal rollover on capital property, the election is

on a property-by-property basis for proceeds of disposition at fair market value. It is an “all or nothing” choice. For registered plans, however, a rollover may be made on any portion of the refund of premiums. The benefit of electing out of the rollover for registered plans is that the spouse can receive the funds outside the plan and no further tax will be payable. For the intergenerational rollover for farm property, a range of amounts between tax cost and fair market value is available.

If the deceased leaves their assets to a qualifying spousal trust, assets that are transferred to the trust within 36 months will be eligible for a rollover. If minimizing capital gains on death is an objective, assets with the highest unrealized capital gain might be used to fund the trust. On the other hand if there are unutilized capital losses or non-capital losses available in the terminal return, the assets with the higher gain might be sold to satisfy other gifts, or if transferred to the trust, an election made out of the rollover for those properties. The value of assets with an unrealized gain transferred to a spousal trust on a rollover basis should be discounted in value. For example, if the Will provides that one-half of the residue is to be contributed to a spousal trust and the other half to a family trust, the assets should not necessarily be divided based on fair market value alone. The unrealized latent tax liability on the assets transferred to the spouse trust should be considered.

During the administration of the estate decisions will have to be made regarding which assets are used to pay debts, satisfy general gifts and other gifts in the Will, and which assets will be used to fund any testamentary trusts. The selection will depend on the purpose of the trust, the terms of the Will, and the tax consequences.

It is important for personal representatives to understand the importance of seeking tax advice. And such advice should not be confined to preparing the terminal return and the estate return. As can be seen from the many exemptions and strategies discussed above and in the materials, there are many opportunities that a tax advisor can uncover to save tax for the estate and the beneficiaries. Often if there is a surviving spouse no tax planning is done. All property is allowed to rollover to the spouse, including capital property and registered plans. This is not always the most effective plan if the deceased had unused capital loss carry forwards or unused capital gains exemption available or other shelter available in the returns of the deceased.

2.7.1 Case Studies for Taxation at Death

Wealth Planning text at 21.6.1 – Taxation at Death – Individual
Note that the principal residence exemption is taken on the property with the most gain. Vacation properties may qualify for the principal residence exemption and the property does not have to be the "primary" residence.

Wealth Planning text at 21.6.2 – Taxation at Death – Married Person
This case study illustrates the problems with do-it-yourself probate fee planning and why having assets pass outside the estate for one purpose can frustrate the testator's intention with respect to distribution to beneficiaries.

Wealth Planning text at 21.2.4 – Principal Residence Exemption; 15.4.2 Calculation of the Principal Residence Exemption
Note that if there is more than one residence for the same year, it is the residence with the highest gain per year that should be selected for the exemption. The "one plus" in the formula makes it advantageous always to elect at least one year on any property as then two years (as the numerator) of the number of years held (as the denominator) will be used in the formula for calculating the exemption available.

2.8 PLANNING WITH TRUSTS

Trusts are an important component of estate planning. Their origin is linked to English history and many of the rules relating to the creation of trusts, the duties of trustees, and the remedies for abuses are also derived from the common law or "judge made law." Trusts are not like corporations, which are legal entities. A trust is a legal relationship whereby property is transferred by way of gift (called a "settlement") by a settlor (the deceased in the case of an estate) to a person (called a "trustee," or in the event of death an "executor," "Estate Trustee" (in Ontario), "liquidator," or "personal representative") for the benefit of certain persons (called "beneficiaries"). In order for a true trust to be created, three certainties must exist – certainty of intention to create a trust, certainty of subjects (i.e., the property settled on the trust), and certainty of objects (i.e., the beneficiaries must be identified or capable of being identified by non-ambiguous objective criteria).

If the seemingly arbitrary rules relating to the creation and ongoing operation of a trust are disregarded there may be serious consequences. Two recent court decisions in Canada relating to the residence and existence of a trust have

made this very clear. If one or more of the three certainties are absent, the tax consequences of all transactions will be determined as if there were no trust. In addition, the arbitrary use of a trust to facilitate particular results in the midst of a commercial transaction should be approached with caution. The use of a trust in such situations is very different from other entities, such as corporations, which are often interposed into commercial transactions for strictly tax or other purposes with impunity. Trusts are more fragile and the CRA may challenge the existence of the trust if only the tax consequences are intended and not a trust relationship.

Trusts are used for many different purposes, but in essence there are two main purposes: protection of assets and tax planning. Trusts separate the control and legal title of property (which is held by the trustee) from use and enjoyment of the property which accrues to the beneficiary. This provides protection for any number of purposes.

- To protect property from the beneficiary's own behaviour.
- To protect property from claims against the beneficiary, such as those of a creditor or spouse.
- To protect the remainder interest for residual beneficiaries after a life interest.
- To provide financial management and security for a special needs beneficiary, such as a disabled or incapable individual.
- To provide for succession of property where the beneficiary is incapable of making a Will,
- To provide unified management of a particular property for use by multiple beneficiaries.
- To preserve or manage a particular asset until arrangements can be made to sell or develop a succession plan (such as a business).

The tax planning benefits of trusts are not necessarily incompatible with using trusts for protection. Often the two are combined. The primary use of trusts for tax purposes is to income split. With *inter vivos* trusts, an understanding of the attribution rules is essential to design trusts for tax purposes and tax advice is essential in setting up, funding, and managing such trusts. While the focus of this course is estate planning, it is also expected that students will have a solid grasp of the attribution rules and other issues relating to *inter vivos* trusts from their

other studies and professional experience. Life insurance can be very effective in trust planning as the tax-deferred growth in a life insurance policy is not subject to the attribution rules, and, since a life insurance policy is not capital property, it is not subject to the 21-year rule.

The use of trusts for protection and tax planning is well developed in the materials in the case studies.

In general, trusts are taxed as individuals, but all of their income is subject to the top marginal tax rate (rather than graduated rates) and as such are entitled to the dividend tax credit available to individuals. In addition, trusts are a conduit for tax purposes. To the extent that income is paid or payable to a beneficiary, that income will be taxed in the hands of the beneficiary and deductible to the trust. In addition, sources of income and their tax attributes can flow through to a beneficiary. Capital gains, including those eligible for the capital gains exemption, taxable dividends, capital dividends, and foreign source income, are all examples of income that retains its character in the hands of a beneficiary.

Where testamentary trusts are included in the Will, steps must be taken during lifetime to ensure they are funded. This may include changing title of jointly held assets into individual ownership and changing beneficiary designations to ensure property passes through the estate. The loss of creditor protection and increase in probate fees need to be factored into the cost benefit analysis. If creditor protection for insurance is a prime objective, a separate insurance trust outside the Will may be a better structure to shelter the insurance proceeds from creditors, particularly in light of the *Carlisle* decision where a separate trust in the Will for insurance proceeds was held to be part of the estate for probate purposes.

Where trusts are funded with life insurance proceeds, this may be implemented by:

- an “in trust for” beneficiary designation,
- a life insurance designation creating a trust in the Will, or
- a beneficiary insurance designation to a separate trust, known as an “executory trust,” the terms of which are created during lifetime, but which is only funded and therefore only created, on the death of the life insured.

Of these the first is not recommended as it is fraught with potential problems. The designation in the Will must be carefully drafted to ensure the proceeds are not included in the estate. In addition, if the beneficiary designation is in the Will, it may be revoked if the Will is revoked by a subsequent Will or otherwise (such as marriage of the testator except in Alberta, British Columbia and Quebec where marriage does not revoke a Will).

2.8.1 Case Studies on Trusts

All case studies for trusts are from the *Wealth Planning Strategies for Canadians* text.

Wealth Planning text at 8.8.1 – Blended Family, Living Common-Law, No Will

This case study illustrates how property passing on death to a surviving partner can result in very different distributions to children from previous relationships when the surviving partner dies intestate. It also illustrates the shortcomings of estate planning through jointly held property with a right of survivorship and by beneficiary designations, as even if Bob and Allison had Wills, much of their property would pass to the surviving partner outside the estate, and there is no guarantee that the survivor would (or would continue to) include the other partner's children in his or her Will. Note that since this is a common-law couple, the rights on intestacy, and to division of family property would depend on the particular jurisdiction in Canada and in some provinces no such rights exist for common-law couples. In all provinces, common-law partners qualify for dependants' relief, except in Newfoundland, Nova Scotia and Quebec where they are not entitled to any part of the estate, and in British Columbia where they are either entitled to the spousal share on an intestacy, or if there is a Will they may be entitled to additional relief as a result of a Will's variation application.

Wealth Planning text at 10.8.1 – Married, With Minor Children

This case study discusses the use of a spousal trust to preserve an inheritance for the children of the marriage in the event the surviving spouse remarries. Note that in addition to the surviving spouse leaving property to the new spouse voluntarily, the children could also be partly disinherited by virtue of rights the new spouse attains to their surviving parent's estate in respect of a claim to property under family law or to support under dependants' relief legislation (or Wills variation in British Columbia).

Wealth Planning text at 10.8.2 – Married, With Adult Children

This case study discusses the benefit of using testamentary trusts to income split between a trust and a beneficiary where the beneficiary is a very low-income earner. If the trust were discretionary, then income may be distributed to beneficiaries who are paying very little, if any, tax while still retaining control over the funds.

Wealth Planning text at 12.6.1 – Disabled Child, Henson Trust

This case study describes setting up a Henson trust for a disabled child to preserve provincial disability benefits. These are not effective in Alberta. In this case, Jonathon, the disabled child, is severely disabled and preserving benefits is very important. In cases where the disability is less severe, parents may want a trust for their child, but may want to provide a higher standard of living than the provincial allowance and other benefits will permit. The level of additional assistance without eliminating benefits varies according to the provincial rules. Where there is uncertainty as to whether preserving provincial benefits will be essential in future or not, a Henson trust can be established with discretion as to whether additional funds will be provided even if the benefits will cease. The means test for provincial benefits is usually annual, so even if additional funds are provided from the trust for a period, the child will not necessarily be disentitled permanently. Providing no further gift over in the trust may not entirely eliminate the concern about conflict of interest between the siblings as trustees and their interest in the trust fund after Jonathon's death, and could cause problems relating to the intestacy. Also, in the unlikely event Jonathon were to marry (the capacity test for marriage is one of the lowest), the spouse would be entitled to the funds. In some cases to relieve the burden from the siblings, and eliminate the concern about conflict of interest, a trust company is recommended as a trustee of the Henson trust either as sole trustee, or as co-trustee with the siblings. This also provides continuity in the event the siblings die before the disabled child.

Wealth Planning text at 16.8.1 – Estate Freeze

This case study will be included in the Study Unit on business owners. Essentially a discretionary family trust can be used to hold the growth shares created as a result of an estate freeze. In addition to other benefits, the use of a discretionary trust permits the owner-manager to postpone the decision as to who will become entitled to the growth shares until a future time. The trust also postpones distribution, ensures control of the growth shares will be in the hands of the trustees, and multiplies access to the capital gains exemption.

2.9 SUMMARY OF KEY ISSUES

Every adult should have a Will, and powers of attorney for property and personal care or health care to ensure that their personal and financial affairs are managed responsibly and in accordance with their wishes in the event of incapacity and/ or death.

Choosing a substitute decision maker for financial management of property is an important decision that should be made after taking into account all the duties and responsibilities and ensuring that the person or persons selected are honest and will act diligently. While honesty and good financial management skills are essential for acting as an attorney for property, these are not essential for an attorney for personal care. The latter should be available to be contacted and make decisions in an emergency situation, and should be willing to carry out the donor's wishes relating to end-of-life care and extraordinary measures.

Choosing an executor wisely is important to effective estate administration. The executors should have the same qualities as an attorney for property, and, in addition, they should be able to work together, if there is more than one. Additionally they must act fairly and impartially and be able to gain the trust and respect of the beneficiaries.

Creditor protection should be incorporated into an estate plan wherever possible. In some circumstances it may be a prime objective of the testator. Insurance can be an excellent vehicle to provide funds on death that are sheltered from creditors if properly structured. In addition, some protection may be available with respect to registered plans.

Charitable giving can be integrated into the estate plan to accomplish charitable objectives and take advantage of tax benefits, such as the donation tax credit and reduced inclusion rate for donation of some property in kind. The benefits of using insurance to fund donations and the capital dividend account should be considered where appropriate.

Probate fee planning can reduce the cost of probate fees on death, but it should be done as part of estate planning as a whole. The savings achieved must be analyzed in light of the cost of implementing probate fee planning, the additional complexity it may introduce to the client's financial affairs, and other planning opportunities that might reap greater benefits.

There are many tax planning strategies that can reduce or defer the tax cost of dying. After death, many options and elections are available to reduce the tax in the final return and make the transfer of wealth to beneficiaries more tax efficient. Special strategies are available where the deceased held an interest in a qualifying private corporation. Tax planning strategies, i.e., income splitting or income sprinkling, are available in some cases through testamentary trusts; and these can reduce the overall tax burden on income from an inheritance.

There are many non-tax uses of trusts. These include protecting beneficiaries from themselves or others, protecting particular property for use by multiple or for future beneficiaries, and preserving capital for a beneficiary after an intervening life interest. Often the tax benefits of trusts can be combined with the non-tax objectives. The two are not necessarily mutually exclusive.

2.10 TERMINOLOGY (SEE ALSO THE WEALTH PLANNING TEXT AT 19.2.7)

Adeem: A gift is said to adeem where the property gifted is no longer owned by the testator. For example, a gift of "my red Porsche" will adeem if the testator no longer owns a Porsche at the time of death. Ademption has a similar meaning.

Abate: The reduction of gifts in a Will to satisfy debts and other expenses of the estate. The residue is exhausted first, then general gifts, then specific gifts other than real property, and last specific gifts of real property. Abatement has a similar meaning.

Executory Trust: A trust that is created outside the Will on the death of an individual. Such trusts are usually set up to be funded with life insurance proceeds on the death of the life insured.

Hotchpot: See Study Unit One.

In Kind: Refers to a transfer to satisfy a gift made by transferring property equal to the value of the required gift rather than in cash. For example, if the Will required a gift of $1,000 to a grandchild, and the Will permitted gifts to be satisfied in kind (sometimes referred to as "*in specie*") the executor could transfer a Canada Savings Bond bearing interest at current market rates with a face value of $1000 in lieu of making a cash gift. Similarly the residue of the estate could be distributed in kind from the assets of the estate without converting the property owned at death into cash.

Intestate: To die without a Will.

Issue: Lineal descendants related by blood or adoption – i.e., children, grandchildren, great-grandchildren. Step-children are not included unless legally adopted. Illegitimate children or other issue are included.

Qualifying Spouse Trust: A trust settled for the benefit of the settlor's spouse whereby during lifetime of the spouse all the income (but not necessarily capital gains) is payable to the spouse and no person other than the spouse may have any right to the capital of the trust. There is a rollover available for capital property transferred to a qualifying spouse trust either during lifetime of the settlor, or to a qualifying spouse trust established under the terms of the Will.

Testamentary Trust: A trust created as a result of the death of an individual, usually in a Will. Executory trusts are also considered testamentary trusts.

REVIEW QUESTIONS AND ANSWERS

Questions

1. Name two properties that can be gifted in kind to charity that will result in a 0% inclusion rate on unrealized capital gains on the property?

2. Identify the tax consequences, and other benefits and drawbacks of designating a charity as the irrevocable beneficiary of a life insurance policy as opposed to designating them as the revocable beneficiary.

3. Explain the benefits of a charitable insured annuity.

4. What exceptions exist to the creditor protection provided to life insurance proceeds on death?

5. What strategies are available to prevent an attorney for property from acting improperly, or neglecting their duties and preventing loss to the estate of the incapable person? Explain why these strategies are effective.

6. List the differences between a power of attorney for property, and a power of attorney for personal care or a health care directive.

7. What are the advantages of obtaining the grant of probate? What are the advantages of not being required to obtain the grant of probate?

8. Mabel is an elderly widow who has three nephews who do not get along. She wants to leave her house to Steve, her RRIF to Colin, and the balance of her estate to her favourite nephew, Garth. She had a Will made 10 years ago giving Garth 50% (two equal shares) of her estate and Steve and Colin 25% (one equal share) each. On the advice of her brother Mable put the house in joint names with Steve, and named Colin as the beneficiary of the RRIF, and changed her Will to make Garth the sole beneficiary of her estate under her Will. Since the house is worth roughly 25% of her assets, and the RRIF worth another 25% at present, Mabel and her brother think this is a good plan to save probate fees. What problems do you see with this plan? What would you recommend Mabel do?

9. What are the consequences of dying without a Will? Assume there is a surviving spouse, and two surviving children, ages 21 and 15. Assume

the assets consist of a non-registered investment account worth $670,000 with $220,000 in unrealized capital gains, and a family cottage that is not eligible for the principal residence exemption (as that was used on another residence) worth $145,000 with $50,000 in capital gains. You do not need to be specific regarding the provincial formula.

10. Jennifer dies leaving her estate to her issue in equal shares *per stirpes*. She is survived by two of five children, Faith and Bess. Of the three deceased children, Hope is survived by three children, Charity is survived by one child but she had another child, Lee, who died but is survived by one child, and Albert is survived only by his spouse, Irene. Jennifer's estate is worth $1,200,000 after all expenses and debts. How will it be distributed?

11. What is the benefit of filing separate tax returns in the year of death?

12. List four ways the income in the terminal return might be maximized. Why might the accountant preparing the terminal tax return decide to increase the income (including capital gains) in the year of death?

13. In what circumstances might the principal residence exemption not be claimed in the year of death? Why should it always be claimed if available, assuming there is a gain on the property?

Answers

1. Publicly traded shares, and employee stock options.

2. Listed below are the tax consequences and benefits and drawbacks of donating an insurance policy to charity, or designating a charity as the beneficiary of a life insurance policy.

    (a) If a newly purchased policy is assigned irrevocably to the charity, the premium payments will be eligible for a donation tax credit. The benefit is that the donor of the policy gets an immediate donation credit during their lifetime. The disadvantage is that there is no donation credit on death, and the donor has no control over the policy (i.e., the donor cannot change the beneficiary to another charity or other person).

(b) Where the charity is named as the revocable beneficiary, the life insured who is the owner of the policy will be entitled to a donation tax credit in the terminal return, as the donation is deemed to be made before death. The advantage is that the timing of the donation tax credit matches the tax liability on death, and naming a charity as a direct beneficiary protects the proceeds from creditors and probate fees. The donor can change the beneficiary if his or her intentions change in the future.

3. A charitable insured annuity provides a charitable donation tax credit matched with a life insurance policy to replace the capital used to purchase the annuity. It achieves charitable objectives without reducing the value of the estate to be distributed to beneficiaries.

4. Life insurance proceeds are not protected from creditors where:

(a) The funds were transferred to the policy for the purpose of evading creditors;

(b) Proceeds are payable to the estate; or

(c) In some provinces, where there is a claim under dependants' relief legislation.

5. There are a number of strategies to ensure an attorney acts honestly and responsibly and no loss is suffered.

(a) Choose the attorney wisely. If the person does not have a proven track record for being trustworthy, good with money, and conscientious, another person should be considered.

(b) Appoint more than one attorney and require them to act together (rather than severally). It is less likely that two or more persons will conspire together to act improperly and each attorney can be the "watchdog" for the actions of the other. In addition sometimes a team of attorneys who are required to work together can ensure that all the qualities required to manage the financial affairs of the donor are present. One person may be an excellent money manager for example, and another may have the time and expertise to ensure proper accounts and records are maintained.

(c) Name a person to whom your attorney must account on a regular basis. While any interested person can request a formal passing of accounts, an informal requirement in the document is less onerous and expensive and this may be a good way to monitor the attorney's actions before abuses or neglect get out of hand and the value of the person's estate is seriously affected.

(d) Name a trust company as the attorney or co-attorney. Trust companies have policies and procedures in place to ensure responsible money management. Although individual employees could act improperly, the trust company would be obliged to rectify any problem, and would have the funds to pay damages or repay any amounts misappropriated. An individual attorney could squander funds, and even if ordered to pay them back, the funds may not be recovered.

(e) Once the person is incapable, family members or other interested persons may be able to prevent loss to the estate by asking for accounts to be prepared by the attorney. If they are not produced, a formal request may be made to the court, which may order passing of accounts.

6. The differences between a power of attorney (POA) for property and a power of attorney (POA) for personal care or a health care directive may include the following:

(a) When is it effective: A POA for property may be effective immediately during capacity of the donor, and may or may not be effective during incapacity depending on whether it is a continuing POA for property (or a mandate in respect of incapacity in Quebec). A POA for personal care is only effective if the donor is incapable.

(b) What type of decisions may be made: A POA for property relates only to financial decisions (i.e., the management of property owned by the donor). A POA for personal care relates to decisions relating to the physical body and physical and social environment of the donor.

(c) Consequences if no POA is made: If there is no POA for property, the public trustee will generally have authority over the assets of the incapable person and it will be necessary for any other person

to apply to the court for a formal appointment as guardian of the person's financial affairs. If there is no POA for personal care, provincial legislation provides a ranking of persons who may consent to medical treatment in the absence of a POA for personal care (or health care directive). There is generally no "back up" in provincial legislation for non-medical or non-health care decisions relating to personal care.

7. Advantages of obtaining probate:

   (a) Third parties, such as financial institutions, land registry offices, and others controlling title to property, will permit a transfer of the property of the deceased into the name of the executor or beneficiary.

   (b) Claims for property by a spouse under family law and claims for dependants' relief may expire only after probate is filed in some jurisdictions.

   (c) It protects the executor from liability in the event the Will is subsequently found to be invalid.

   (d) The application process provides an opportunity for beneficiaries or others to raise objections to the Will or bring forward another Will.

   Advantages of not obtaining probate:

   (a) Savings – Probate fees are avoided.

   (b) Privacy – The Will is not available for public inspection so the affairs of the deceased and the family may remain private.

   (c) Savings – Where the value of assets requiring probate is reduced, but the requirement for probate is not completely eliminated, there may also be a reduction in executor's fees and legal fees, depending on whether they are calculated on the value of assets subject to probate.

8. There are a number of problems.

   (a) Fluctuating Values: While the value of assets may achieve Mabel's goals today, over time the value of these various assets may change

significantly. The RRIF has a required minimum payout every year starting in the year Mabel turns 71 and it may be worth much less in the future. The house and the assets passing through the estate may also change in value.

(b) Loss of Control: Mabel may want to sell the house in future. For example, it may become too much for her to maintain or she may need to go into a nursing home and selling the house may make good economic sense. If Steve is added as a joint owner, she would have to get Steve's consent to sell the house, and then she will have to change her Will if she wants to ensure that Steve is not disinherited. If she is no longer capable when the house needs to be sold she may not be able to change her Will.

(c) Uncertainty regarding joint ownership of the home: A gratuitous transfer to a person other than a spouse or minor child is subject to the presumption of resulting trust. Mabel must document her intention to make the transfer of the home a true gift to Steve. Otherwise it will remain in her estate, be subject to probate fees, and will be inherited by Garth.

(d) Loss of Principal Residence Exemption: If two people own a residence they must both use their principal residence exemption on a sale if the gain is to be fully sheltered. If Steve does not "ordinarily inhabit" the property as his residence, then it will not qualify as his principal residence, and Steve will have to pay tax on any gain that accrues after the transfer of the property on his share. If Steve was Mabel's child it would qualify as his principal residence but if Steve has his own residence he will likely want to use his exemption on his own home.

(e) Tax on the RRIF: The tax on the RRIF is paid out of the estate. As Garth is the only beneficiary of the estate, his share will be reduced by the tax on the RRIF paid to Colin. Mabel's plan ignores the tax liability arising on the RRIF on death that is a liability of the estate.

Mabel could do probate fee planning.

(a) Assuming she is 65, she could do an alter ego trust, and leave Colin as the beneficiary of the RRIF. She could include a hotchpot clause in the trust so that on her death an adjustment is made to Colin's share to ensure he receives his 25%. A cost benefit analysis would have to be done to ensure that the future savings in probate fees is worth the initial legal cost of setting up the trust, transferring property to the trust, and the ongoing costs of preparing annual tax returns and paying any trustee fees.

(b) But it may be better if her estate is modest and the cost of an alter ego trust is not warranted, just to do the beneficiary designation on the RRIF and let the house and other assets go through her estate under her Will. A hotchpot clause could be used to equalize Colin's interest. Although this plan still attracts probate fees, Mabel needs to understand that the cost of probate fees is relatively minor and the cost is well worth avoiding the problems listed above that would result in a distribution that is unpredictable, and probably not what she intends.

(c) If there will not be enough in the estate to equalize the assets even with a hotpotch clause, then it may be better to have no direct beneficiaries on the RRIF, and a specific distribution in the Will.

9. The consequences of dying without a Will include the following:

(a) The estate will be distributed according to the provincial formula. Generally the surviving spouse will get the preferential share (in Manitoba the surviving spouse will get 100% unless the children are step-children of the surviving spouse) and the children and the surviving spouse will share the balance of the estate. Depending on the province, generally if there is more than one surviving child, the children will share two thirds of the balance with the spouse receiving one third of the amount in excess of the preferential share.

(b) Someone must apply to the court to be granted the authority to administer the estate as an "administrator," "liquidator" in Quebec, or "estate trustee without a Will" in Ontario.

(c) Delay in managing the estate. A personal representative under a Will has immediate authority. However, in the case of an intestacy no one has authority until the appointment of an administrator is made by the court. In addition, there are additional legal requirements for an intestacy that will delay the administration of the estate. In some jurisdictions there is a time period before assets from an intestate estate can be distributed.

(d) Additional costs. Additional legal costs will be incurred on an intestacy. In addition the administrator may be required to post a bond in order to be granted the appointment.

(e) The Public Trustee will have control of the inheritance of the minor child.

(f) The minor will receive his or her inheritance upon attaining age 18 or 19 (depending upon the jurisdiction) and the 21-year-old will receive his or her inheritance once the estate is ready for distribution.

(g) There will be income tax on death and since the spouse does not inherit the entire estate, it will not be possible to shelter all the capital gains with the spousal rollover. It may be possible to minimize this problem by carefully selecting the individual holdings in the portfolio and transferring those with the greatest gain to the spouse. However, in valuing the assets to be distributed, some discount may have to be given to property transferred with an unrealized capital gain.

(h) The Court will have no guidance regarding the appointment of a guardian for the minor child. Usually the court will give weight to the parent's wishes – here they are unknown.

(i) Delay in administering investments. The value of the portfolio could suffer if important decisions need to be made before an administrator is appointed.

(j) Inflexibility regarding investment policy and administration of the estate. The administrator will be restricted to the authority granted under common law and the statutes in the province. A Will could

have permitted greater flexibility regarding investments and broader powers relating to administration.

10. Distribution of Jennifer's estate is as follows:

(a)	Faith	$300,000
(b)	Bess	$300,000
(c)	Each of Hope's 3 children	$100,000
(d)	Charity's surviving child	$150,000
(e)	Lee's child	$150,000

Explanation (not required as part of the answer): There will be a primary division into four equal shares. No share is created for Albert as he has died without issue. Each surviving child will receive one share, and each surviving grandchild of a deceased child will divide the share of his or her deceased parent. There will be a division of Charity's share into two equal parts for each of her children who either survived her or died with issue surviving, in the same manner as Jennifer's estate was divided into four shares. Lee's child will receive the part of Charity's share created for Lee.

11. More income can be taxed at the lower marginal rates.

12. Income might be maximized in the terminal tax return by electing one of the following options:

    (a) Electing out of the spousal rollover on certain properties,

    (b) Refraining from electing to deduct income from a RRSP or RRIF that is eligible for a rollover (to spouse, dependent minor child, or dependent disabled adult child) so all or a portion of the refund of premiums is taxed in the terminal return,

    (c) Electing out of the inter-generational rollover for family farm property or a family farm corporation or family farm partnership, or

    (d) Electing out of a spousal rollover on property qualifying for the capital gains exemption.

Income might be increased in the year of death by the above means because there may be "shelter" in the terminal return from tax, and including these sources of income in the terminal return will save taxes in respect of the particular property in the future. For example, electing out of a rollover of capital property in a, c, or d above will result in the estate or the beneficiary having an increased adjusted cost base (at fair market value except for farm property where the election permits a range) thereby providing future shelter from capital gains. In the case of b, the beneficiary of the registered plan will receive the refund of premiums tax free without being required to contribute them to his or her own plan.

Shelter in the terminal return could result from:

(a) Unused capital losses in the year of death or carried forward from previous years that are deductible against all sources of income in the year of death,

(b) Unused non-capital losses available in the year of death,

(c) Low income in the year of death permitting additional income to be taxed at lower marginal rates,

(d) Availability of the capital gains exemption, or

(e) Unused charitable donation tax credits or other tax credits.

13. The principal residence exemption might not be claimed if:

(a) It was not available because it had been claimed in all previous years. However, because of the plus one in the formula it should be claimed in the year of death on at least one property – subject to c below.

(b) It might not be claimed on a particular property (where more than one property owned at death qualifies) since only one principal residence for any particular year of the holding period may be claimed.

(c) It may have been claimed for all available years, including the year of death, by a spouse.

The principal residence exemption should always be claimed if available since the property passes to the estate or beneficiary at fair market value whether the exemption is claimed or not. NOTE: also, the one plus in the formula increases the amount sheltered by the exemption even if only claimed for one year.

STUDY UNIT THREE

FAMILY ESTATE PLANNING

Knowledge Objectives

Skills Objectives

Topics Covered

Related Textbook Readings

3.1 INTRODUCTION 3-5

3.2 COMMENTARY ON ASSIGNED READINGS AND ASSIGNED CASE STUDIES 3-7

3.2.1 Choice of Beneficiaries 3-7

3.2.2 Undue Influence and Protecting the Estate Plan 3-8

3.2.3 Unequal Distributions and Disinheriting Children 3-9

3.2.4 No Spouse, Children or Other Surviving Issue (Single or Widowed) 3-11

3.2.5 Children 3-12

3.2.6 Parents 3-15

3.2.7 Seniors 3-15

3.2.8 Trusts for Disabled Beneficiaries 3-16

3.2.9 Marital Status 3-18

3.2.10 Rights of a Spouse or Common-Law Partner to Division of Property under Family Law 3-20

3.2.11 Change of Marital Status 3-21

3.2.12 Obligations on Death to Spouse and other Dependants re Dependants' Relief in Lieu of Support 3-24

3.2.13 Unjust Enrichment and Other Equitable Remedies 3-25

3.2.14 Second Marriage or So-Called "Blended Families" 3-25

3.2.15 Vacation Properties 3-26

3.2.16 Case Studies 3-29

3.3 SUMMARY OF KEY ISSUES 3-31

3.4 TERMINOLOGY 3-33

REVIEW QUESTIONS AND ANSWERS 3-34

Study Unit Three

Family Estate Planning

Learning Objectives

Knowledge Objectives

Upon completion the student will appreciate how estate plans are tailored to suit different family situations.

Skills Objectives

Upon completion the student will, in relation to the topics listed below, be able to:

- Identify issues and planning strategies that are appropriate to the client's family situation and the property to be distributed to family members
- Assess the client's obligations to a current or former spouse or common-law partner
- Assess the client's obligations to dependants and other family members
- Identify alternative planning strategies to satisfy the client's legal obligations to family members
- Analyze the client's family situation and discuss and evaluate the client's objectives with respect to family members as beneficiaries
- Identify alternative planning and distribution strategies to meet the client's estate planning objectives with respect to family members
- Identify the planning issues for different family situations, such as marital status, with or without children
- Discriminate among alternative planning strategies and recommend preferred alternatives to the client to address family support objectives, obligations, and family distribution objectives
- Explain the potential estate planning problems that arise from blended families
- Identify issues relating to "uneven" distributions to children
- Identify issues and make recommendations with respect to distribution of a recreational property to family members

Topics Covered

Planning for particular family situations, including:

- Single
- Common-law Couples
- Engaged
- Married
- Separated
- Divorced
- Blended Families
- Widowed
- Children/Grandchildren
- Disinheriting Beneficiaries
- Protecting Inheritance from Son- or Daughter-in-Law
- Income to Survivors
- Disabled Persons
- Elderly Parents
- Vacation Properties

Related Textbook Readings

Wealth Planning Strategies for Canadians
Christine Van Cauwenberghe, B.Comm. (Hons), LL.B., CFP, TEP

Chapter 2 Single
Chapter 3 Common-Law Couples
Chapter 4 Engaged
Chapter 5 Married
Chapter 6 Separated
Chapter 7 Divorced
Chapter 8 Blended Families
Chapter 9 Widowed
Chapter 10 Children
Chapter 11 Grandchildren
Chapter 12 Disabled Persons
Chapter 13 Elderly Parents
Chapter 14 Seniors and Retirees
Chapter 15 Vacation Properties
Chapter 17 Family Property

3.1 INTRODUCTION

Estate planning rarely takes place without significant consideration of the individual's family situation.

Family members are typically the first choice as beneficiaries and there may be legal obligations to provide for a spouse, partner or dependent child. Everyone has parents, and they may or may not be included in the client's list of potential beneficiaries. Many people marry or enter into common-law relationships or other conjugal relationships and want to provide for their spouse or partner. If they do not want to provide for a spouse or partner, there may be a legal obligation to provide support or property and the estate plan should address such obligation. Failure to do so may invite estate litigation and disrupt the administration of the estate and the planned scheme of distribution. Children are also important family members in the estate plan, both as potential beneficiaries, and because there may be legal obligations to provide support if they are minors or otherwise dependent on the parent because of a disability.

The nature of the relationship between the client and family members, and the relationship among family members may shape estate planning objectives. The client may not want to include estranged family members in his or her Will or provide the same share to all family members in the same blood relationship to the client. Family members who do not get along may pose problems relating to choice of executor. In addition, the estate plan may need to be designed to minimize conflict, or at least reduce the risk that it will disrupt the administration of the estate.

If the client has particular assets that are to be distributed in kind to family members, such as a business or recreational property, the family tree and family dynamics will be relevant to the estate plan and the distribution scheme.

This Study Unit will examine estate planning in light of the client's family situation. A sound grasp of the topics covered in Study Unit One: Estate Planning Process, and Study Unit Two: Personal Estate Planning is assumed.

There is no pre-determined estate plan that fits a client based solely on family situation. The client's estate planning objectives will be shaped by family situation but will also be a result of the nature of the client's assets, the extent of his or her wealth, values, stage in life, and the particular relationship the client has to

his or her family. However, family situation is one of the most significant factors in determining the client's estate planning objectives.

The advisor must be able to uncover the client's family members, identify the "natural objects of affection," and understand how the family situation may affect the client's objectives and obligations. The client's objectives, with respect to distributions of property to particular family members, must also be assessed by the advisor with respect to how this might affect other family members. Distributions of property in kind, and unequal distributions to children or their families will raise issues that the advisor must be prepared to identify and discuss with the client.

This Study Unit provides an opportunity for the advisor to learn to apply his or her technical knowledge to particular family situations and develop an estate plan that meets the client's objectives and legal obligations with respect to family members.

Strategies to achieve family succession objectives and meet legal obligations to family members are discussed in the material. Other objectives, including tax planning, and preserving family harmony (or minimizing conflict), must be woven into the estate plan. The advisor will need to understand all of the client's objectives and be able to identify a number of possible strategies to achieve them.

The ability to identify, discuss, and evaluate alternative estate planning strategies, and make recommendations to assist the client in choosing the appropriate strategies among competing priorities is the essence of estate planning. It requires an understanding of the technical aspects of estate planning, including legal and tax issues. It requires an understanding of the client's family situation and knowledge of the client's estate (i.e., the nature and value of property that will pass on death). And lastly, it requires an understanding of the client's thinking and values that shape the estate planning objectives. These include the client's views or "philosophy" about how wealth should be transferred to and divided among family members, the client's charitable objectives, his or her tolerance for complexity, and the importance of tax minimization.

Ultimately the client will need to choose among competing objectives and strategies with the assistance of the advisor. The advisor should be able to make recommendations by presenting the advantages and disadvantages of the various strategies, how they interact, and how they affect the overall plan, including the

distribution to family members. A skilled advisor will be able to prioritize the decision-making process for the client. Identifying the essential objectives will often put other priorities into better perspective. For example, saving taxes may be a priority and the client may be prepared to make a significant charitable donation to reduce taxation on death. However, few clients will want to make a donation so large that the inheritance intended for family members is reduced significantly.

The advisor may provide his or her opinion as to the recommended course of action in light of the client's objectives. However, the advisor must make it clear to the client that it is the client's responsibility to make his or her own decisions.

3.2 COMMENTARY ON ASSIGNED READINGS AND ASSIGNED CASE STUDIES

3.2.1 Choice of Beneficiaries

Family members are typically beneficiaries of the estate, and often the only beneficiaries. The spouse or partner and children are the usual beneficiaries if the client is in a traditional family. The terms "mom and pop Will" or "I love you Will" have been coined to refer to a Will that "leaves everything to you, dear, and then to the kids." This loosely describes the most common distribution to family members, being everything to any surviving spouse or partner, with a gift over to children in equal shares and a further gift over to issue of a predeceased child in equal shares *per stirpes*.

Clients often ask about the typical distribution to family members. While it is perfectly appropriate to set out the most common distributions, assumptions should never be made about the client's wishes, nor should the client be given the impression that a particular distribution to family members is the "right" thing to do, or is what family members are entitled to receive.

For example, often clients will want to protect a child's inheritance from any claim that may be made by that child's spouse or partner in the event of a breakdown of the relationship. But this should not be assumed. Is it possible that the client has a concern about the child's ability to manage the inheritance wisely, and wants to ensure that the child's spouse has control over the inheritance or is adequately provided for along with any children of the marriage? The plan for the child's inheritance might be completely different in the latter case.

The above example illustrates how the family tree alone cannot be used to produce a formula for the plan. The full family situation, including the client's concerns and wishes to benefit and protect family members, needs to be examined.

The distribution to family members may also need to be modified in light of other estate planning objectives. It is not unusual for these to be developed during the estate planning process with the assistance of the advisor's input. The advisor's role is to identify potential planning strategies applicable to the client's situation. The client may initially be unaware of the possible uses of trusts in estate planning. For example, the client may learn that a trust can be created to protect an inheritance of a special needs or "black sheep" beneficiary. After consideration of other possible objectives discovered during the estate planning process the "typical" distribution may be altered significantly.

3.2.2 Undue Influence and Protecting the Estate Plan

Individuals who do not have a spouse or partner and no children or other issue may have difficulty deciding who will benefit from the estate. If there are siblings, then they may be beneficiaries, but sometimes there will be a desire to drop the inheritance down to the next generation by making nieces and nephews beneficiaries. Charities and friends are also possible beneficiaries. Since the client may not have obligations or emotional attachment to dependants or other close family members there is a unique freedom to choose beneficiaries. Such clients may change their beneficiaries often, and may be more prone than other individuals to fall victim to predatory behaviour of unscrupulous persons who befriend them for financial gain.

The advisor must be alert to the potential for undue influence and avoid supporting or implementing an estate plan without taking steps to ensure the client's instructions are given independently. This is true in all situations, but the client may be more vulnerable if elderly, has reduced or diminished cognitive ability, is dependent on others for care or companionship, has few or no family members, or is isolated or estranged from his or her family.

The vulnerability of aging individuals is increasingly becoming a major concern in estate planning, planning for incapacity and the management of a client's estate by others under a power of attorney. The estate plan should take into account possible future problems relating to the diminished capacity or risk of undue influence.

For example, while typically all assets are left to the surviving spouse, the surviving spouse may not ultimately dispose of the assets as the client would have wanted or anticipated. A surviving elderly spouse may become the victim of a predatory marriage. Or children may start to manipulate the surviving parent's emotions and influence them to redistribute wealth in an inappropriate manner.

Two of the most common estate planning mistakes is to assume that the surviving spouse will always "do the right thing" and that children will behave altruistically and in the best interests of each other rather than in their own self-interest. Children often acquire a sense of entitlement over time relating to their parent's estate that may arise from what is perceived as fair, deserved, or earned by caring for the aging parent. This may not be in accord with what was planned when the parents were both alive, healthy and independent. And while it is possible to set aside a Will in the event of undue influence, this is a very onerous requirement for family members, and often the influence exerted on the surviving spouse may fall short of influence that is "undue." (See 10.5.8 Ensuring Your Child Receives an Inheritance in the *Wealth Planning* text.)

Where the succession of particular assets such as a family business or recreational property are an important component of the estate plan, it may be appropriate to implement a strategy to protect that plan from possible alteration by a surviving spouse or partner. This might also be considered where there is a possibility the surviving spouse may be prone to being influenced to favour one child over the other in the future. This might be a concern, for example, where the following scenarios exist:

- there is a history of sibling rivalry,
- a concern that some children are greedy or manipulative,
- the spouse is inclined to prefer some children over others, or
- the spouse is easily influenced.

Using a spousal trust can be an effective strategy to protect the estate plan.

3.2.3 Unequal Distributions and Disinheriting Children

Children generally expect that they will share equally in their parents' estate. If the distribution among children is not equal, the client should be aware that children may resent the parent or each other, and this may not be the legacy the

parent wants to leave. The advisor should inquire into the reasons for unequal distributions. Common reasons relate to children's respective financial well-being, the child's needs, the parent's approval or disapproval of the child's lifestyle or behaviours, or the relationship between the child and the parent.

For example, perhaps one child has received more financial assistance from the parent already. In some cases this may result in the parent deciding to leave less to such a child. On the other hand, if the child has more need than the other children the parent may actually want to leave such a child a greater portion of his or her estate. The reason for the financial assistance must be examined. Is one daughter widowed and in poor health with diminished earning capacity and dependent children? Or is one son completely irresponsible with money disregarding his own financial security and that of his wife and children? The strategies to address these situations differ as may the degree to which the other children may be comfortable with the parent's decision as to distribution.

To dissuade disgruntled family members from disputing an estate or making a claim, and prevent a successful challenge to a Will, a number of strategies may be employed (see 10.5.9 Disowning a Child in the *Wealth Planning* text). These may include any of the solutions set out below.

- Take steps during the estate planning process to demonstrate or ensure the testator has capacity and is free from undue influence. The solicitor preparing the Will may ask for an assessment. A record of the discussions and questions intended to probe for capacity should be made and retained. Instructions should be given and confirmed without the supervision or presence of beneficiaries or other interested parties.
- If there is a significant alteration in the plan from previous Wills, the reason should be recorded. This may provide support in future to show there was no undue influence. A Will can be set aside if undue influence is proved (on a balance of probabilities) by the challengers. Suspicious circumstances may constitute part of the evidence that suggests undue influence. An unexplained change or one that is not reasonable or rational may be a suspicious circumstance.
- A gift may be made to family members who may challenge the Will on condition that the gift will fail if they dispute the Will or make any claim against the estate. Note that such conditions may be void

and the lawyer preparing the Will must ensure that there is a specific gift over in the event the gift is to fail. In addition, if the Will is successfully challenged, the conditional gift will fail in any event along with the Will. The client should be aware that such a clause cannot prevent a claim that the Will is invalid or a successful family law claim for division of property or a claim for dependants' relief. However, if the gift is large enough, it may make the beneficiary less likely to litigate. Note also that in Quebec the right to patrimony overrules the Will in any event without making any claim.

- Discuss the distribution with family members so they understand the reasons and have the opportunity to discuss the decision with the parent during his or her lifetime. While this may not prevent conflict, it will at least eliminate the element of surprise that may otherwise be the "last straw" in converting an unhappy and grieving family member into a litigant. Children may be more likely to respect the parent's decisions if the parent has been open and honest, and there has been a dialogue where both the parent and the children have had the opportunity to express their own views of what is fair and appropriate.

3.2.4 No Spouse, Children or Other Surviving Issue (Single or Widowed)

Singles without children may have difficulty identifying appropriate persons to act as attorneys under a power of attorney, executors, and even beneficiaries. The same may apply to the surviving partner of a relationship where there are no children. A trust company may be a good option to act as executor and attorney for property. Siblings, nieces and nephews, charities, and friends may be likely beneficiaries.

Where there was a marriage or other conjugal partnership that ended on the death of the spouse or partner, it is not unusual for the surviving spouse or partner to divide the estate between his or her own family and that of the deceased spouse or partner who died first, particularly if the surviving spouse inherited the bulk of the estate on the first death. However, it is possible the surviving partner will not provide for both families and disinherit the family of the pre-deceased partner. For example, consider Mary and Alice, a same-sex couple with no children. Mary dies and Alice inherits her entire estate under Mary's Will. Alice dies intestate and her entire estate is distributed to her brothers and sisters. Mary's family receives

nothing. Mary could have prevented this outcome if she had provided a trust for Alice in her Will with a gift over to her own family.

Individuals who do not have close family members may be more inclined to make organ and tissue donations. This is governed by provincial legislation, and the client should be encouraged to investigate and take the steps necessary to ensure that the legal requirements have been completed and that in the event of death their wishes will be known.

Where a person has no children or other issue the estate plan should consider the possibility of children in the future. Even where child-bearing age has been passed, there is always adoption. In addition, men may have children in advanced years. While marriage revokes a Will (except in Alberta, British Columbia and Quebec), having children does not. So the Will should always provide for the possibility of issue, even if remote, as one of the "what ifs." For the same reason, beneficiary designations for insurance and registered plans to other family members may not be appropriate if it is possible that children may be born in future. The designations must be reviewed if children are born. If children are anticipated in future it may be more appropriate to make the estate the beneficiary so children can be provided for, and trust provisions apply.

3.2.5 Children

For dependent children a trust should always be provided to ensure that the public trustee or other public official in the province does not obtain control of the child's inheritance. This alone is a very good reason for parents to write a Will.

Parents usually do not want their children to receive their entire inheritance when they reach the age of majority. Two questions result: when should children receive their inheritance, and who will manage any funds set aside for them in trust in the meantime?

The timing of distributing an inheritance to children is very personal and varies according to the parent's philosophy and the children's particular characteristics. If there is no specific concern, an age for distribution can be chosen with distributions of capital at the discretion of the trustee throughout the duration of the trust. Income is usually discretionary during minority, and may continue to be discretionary after minority or automatically payable. Staged capital distributions

may be required prior to termination of the trust as well, although this may not be necessary if there is a general power to encroach on capital.

The degree of discretion given to the trustees may depend on the identity of the trustee. For example, to make decisions less onerous for a family member, there may be less discretion, but more generous required distributions. If the trustee is a trust company or there is no concern that beneficiaries may pressure the trustee, broader discretion may be granted.

If there is a specific concern regarding children, then special trust terms may be considered. See 10.5.3, 10.5.5, and 10.5.6 in the *Wealth Planning* text for details. These might include any of the situations outlined below.

- An incentive trust that attempts to motivate or reward a beneficiary for particular behaviour or achievements, such as completing post-secondary education. These work best where the beneficiary and the trustee are given the opportunity to work together to agree on goals and consequences. Parents should be discouraged from being overly optimistic about the utility of these trusts to achieve unrealistic changes in their children's personality or lifestyle.
- A spendthrift trust that manages property for the child over his or her lifetime or an extended period to provide financial security and protect the child from his or her own behaviour.
- A creditor protection trust, whereby distributions are prohibited if the beneficiary's assets are subject to seizure by creditors. In such a case distributions may be permitted to other family members to ensure dependants or the spouse or partner may maintain their lifestyle. Often this is combined with a spendthrift trust.
- A protection trust to manage the property of a child with special needs and provide financial security. For example, a child with a serious illness may need or prefer to have an inheritance managed for him or her.
- A Henson trust to protect the entitlement of a disabled child to provincial disability benefits. This is province specific and is not available in Alberta.

- A trust for a child who is mentally incapable to prevent intestacy on death of the child and ensure that the capital of the trust devolves to appropriate family members.
- A discretionary family trust to protect an inheritance from the claims of a spouse under family law. See 13.5.2 of the *Wealth Planning* text.

Parents may want children to be trustees, but if the purpose of the trust is to preserve wealth and ensure it is responsibly managed until children mature, other persons should be trustees. From a legal perspective as well, the purpose of the trust may be frustrated if the child is the trustee. For example, neither a Henson trust nor a creditor protection trust will work if the child is the sole trustee, and some advisors may insist that the child not even be a co-trustee of such trusts, for fear their purpose may be thwarted if third parties argue that even as co-trustee the child has a degree of control over distributions. Siblings may be appropriate. However, putting a family member in the position of trustee can strain family relationships if the beneficiary attempts to pressure the trustee to make distributions. Alternatively, the trustee may give in to pressure by the beneficiary to keep the peace, and the purpose of the trust may be compromised.

Testamentary trusts may also be considered for children and their families to permit income splitting between the trust and the child, in certain cases (such as where the beneficiary qualifies for the disability tax credit) and income sprinkling to low-income family members. Typically such trusts provide broad discretion to trustees to permit maximum flexibility to achieve optimal tax savings. Trusts that are designed for other purposes may still provide opportunity to income split and income sprinkle even without such broad discretion. Where discretion can be provided with respect to distributions of income and capital, the child's issue, and the spouse or common-law partner of the child and issue can be considered as potential beneficiaries to expand the income splitting opportunities.

Inter vivos trusts may be created for children for income tax reasons, but more planning is required than for testamentary trusts as the attribution rules will apply with respect to beneficiaries who are under age 18, and the "settlor" attribution rule may also be a problem if the trust is not carefully structured. *Inter vivos* trusts for protection are created less often for children and their families because there may be less need for a trust during the parent's lifetime, and the 21-year rule can

be deferred longer if the trust is not created until the death of the parent. The tax on split income (i.e., the "kiddie tax") is potentially applicable as well.

3.2.6 Parents

There may be an obligation to support parents under provincial law and parents may be able to make a dependants' relief claim against the estate of the child if the child provided support at the time of death. Provincial rules vary as to the eligibility of a parent to make a claim for dependants' relief. See 19.6 in the *Wealth Planning* text.

Where parents are being supported, this support might be made more tax effective by providing for parents through an *inter vivos* trust, or a testamentary trust in the event the child dies before the parent. This might be appropriate where the child has sufficient funds to contribute to a parental trust, and the parent or parents have little or modest amounts of income. After the death of the parent, it may be possible to make the children of the settlor or testator the beneficiaries of the trust. The child as settlor cannot make him- or herself the residual beneficiary of an *inter vivos* trust without the attribution rules applying to attribute income to the child.

If the situation is reversed and the parents will be leaving significant wealth to their adult children, consideration should be given to asking the parents to change their Wills to create testamentary trusts for their children and their families in order to benefit from the tax savings from income splitting with a testamentary trust where a beneficiary qualifies for the disability tax credit and income splitting by "sprinkling" income to grandchildren or other family members who are in the lower marginal tax brackets. See 13.5.1 in the *Wealth Planning* text.

3.2.7 Seniors

As discussed in chapter 14 of the *Wealth Planning* text, it may be desirable to limit the net income of a person who is 65 or over to preserve rights to certain benefits and tax credits. The amount of taxable investment income can be reduced by converting capital investments into an annuity or permanent life insurance policy or combination of these.

While seniors do not generally consider insurance as part of their financial or estate planning, policies at standard rates are available up to age 80 and rates may

be considerably lower if a joint last-to-die policy is purchased by both husband and wife. Policies can be used to reduce net income (see above), fund taxes in respect of a specific gift in the Will such as a vacation property, or provide a mechanism to reinvest required withdrawals from RRIFs. Where insurance is used to pay taxes or fund an inheritance, the beneficiary of the policy should either be the estate, or an insurance trust. Otherwise the insurance proceeds will not form part of the estate and may not be used for the intended purpose.

3.2.8 Trusts for Disabled Beneficiaries

A Henson trust is a discretionary trust that is designed to preserve the right to provincial disability benefits. These benefits may include not only a monthly disability allowance, but other valuable benefits such as the right to live in an assisted living facility, drug benefits, therapy, and social programs. In some cases the value of the additional benefits exceeds by far the value of the allowance.

The nature of the assistance available and the nature of the disability need to be examined in determining if a Henson trust is appropriate. If the individual is permanently disabled, will never be able to support him- or herself, and is totally dependent on the disability benefits and other income-tested assistance, then preserving the right to benefits may be a high priority. However, if the individual is able to work or would be able to enjoy a more generous standard of living without benefits if the inheritance were available to fund their lifestyle, then a Henson trust might not be necessary or even appropriate.

The advisor should avoid rushing to conclusions that a Henson trust is automatically required where a disabled child is being considered as a beneficiary. If the parents are wealthy enough and the disability does not completely restrict the ability of the individual to enjoy the benefits of wealth, it may be more appropriate to provide a more generous inheritance. Even if a trust is employed, it may not need to be as restricted as a Henson trust, although a Henson trust can be drafted to permit more generous discretionary distributions such that the means test for disability benefits is exceeded where appropriate.

Under provincial rules, certain assets such as a home and limited amounts of cash are permitted without disqualifying the beneficiary from benefits. These rules vary by province and the current levels are listed in section 12.5 Jurisdiction Differences of the *Wealth Planning* text. The trustees of the Henson trust must be aware of the rules as to permitted assets and income levels in order to ensure

that the beneficiary continues to qualify, or can make an informed decision as to when it is not necessary to preserve the entitlement. The means test is an annual test, and even if the beneficiary exceeds it in one or more years, he or she can qualify in future years, assuming the disability continues.

The choice of trustee for a Henson trust, or any trust for a child where protection is required can be difficult. As pointed out in the *Wealth Planning* text, appointing the child's brothers or sisters can create a conflict of interest if the siblings or their issue are contingent beneficiaries. This may also be an unwelcome burden on the parents' other children. A trust company is often a good choice where the amount in the trust is sufficient to warrant the cost. Using a trust company can have the following advantages:

- Trust companies are generally familiar with the rules relating to Henson trusts and can ensure that the entitlement to benefits is preserved if that is a priority.
- Trust companies provide permanent existence and will be available to manage the termination of the trust and final distribution of funds when the beneficiary dies – whereas other children may be elderly at this time or may have pre-deceased the beneficiary.
- Trust companies will be impartial in exercising discretion with respect to distributions to other family members.
- Trust companies can relieve other children or family members from the long-term burden of administering the trust.

Henson trusts often have other family members as discretionary beneficiaries. Typically brothers and sisters and their issue are discretionary beneficiaries during the lifetime of the disabled beneficiary and are the ultimate beneficiaries on termination of the trust. The testator typically wants other family members to benefit from the funds in the trust if they are not needed for the disabled child, or if there are funds remaining on the death of the child. Some lawyers insist on the existence of other discretionary beneficiaries to ensure that the provincial authorities will not "look through" the trust. The choice of children as trustees may be problematic because they and their families are potential beneficiaries, and the addition of a third party as co-trustee, including a trust company, may be a solution. In addition, in some family situations the parents are completely comfortable that their children will always ensure that the best interests of their

disabled sibling are respected. It may still be wise to include a trust company or other mechanism for a successor trustee in such situations since someone will need to administer the trust on the death of the trustee and the trustee may die before the beneficiary.

A trust should always be used if the disabled person is mentally incapable so that the trustee can manage the property for the beneficiary and the trust can provide for the appropriate succession of the trust funds when the beneficiary dies.

3.2.9 Marital Status

Marriage creates rights and privileges and significantly affects estate planning issues. The following may depend on marital status:

- right to division of family property during lifetime,
- right to division of family property on death from the estate of a deceased spouse or partner,
- the right to occupy the family home,
- right to support during lifetime,
- right to claim dependants' relief on death of the other spouse or partner in lieu of support,
- right to a distribution on intestacy, and
- right under the Will (since divorce generally disentitles the spouse to inherit under the Will).

Under federal law, all jurisdictions in Canada are now required to recognize same-sex marriage. Therefore married same-sex couples have identical rights to other married couples. In addition, common-law couples are recognized for federal pensions and the Canada Pension Plan after 12 months co-habitation. For federal income tax purposes, common-law couples are treated identically to married couples after 12 months co-habitation or while co-habiting and parenting a child together. Other rights vary by province as generally property and civil rights are within the jurisdiction of the provinces under constitutional law in Canada. It is important to understand that the relationship may be recognized for some purposes and not for others, and that the status accorded common-law couples varies dramatically in Canada from one jurisdiction to another. In

general, British Columbia, Manitoba and Saskatchewan treat common-law and married couples identically. New Brunswick, Newfoundland, Nova Scotia, Ontario and Quebec provide few, if any, rights to common-law couples (except where registration to recognize the relationship is provided for under provincial law). The remaining jurisdictions fall in between by recognizing common-law couples for some purposes, but not necessarily giving them identical rights to married couples. The definition of common law varies from province to province as well. Section 3.9 of the *Wealth Planning* text summarizes the rights of common-law couples in jurisdictions across Canada to dependants' relief, rights on intestacy, and division of family property.

In some jurisdictions, common-law couples can formalize their common-law relationship without entering into marriage, which may result in them being treated as married or given the same rights as qualifying common-law couples depending on the jurisdiction. In Quebec, for example, couples may enter into a contract for a civil union that will result in them being treated identically to married couples. In Alberta couples can register to be treated as Adult Interdependent Partners, which is the Alberta term for common-law couples that have certain rights recognized. Nova Scotia and Manitoba also have registration options for common-law couples – section 3.9 of the *Wealth Planning* text.

The recognition of common-law relationships is based on the length of time a couple has lived together in a conjugal relationship. For federal income tax purposes this period is usually 12 months (or shorter period of time where there is a child). For most provinces the period is two or three years. Where there is a child born of the relationship (or sometimes an adopted child) there may be a requirement that the relationship be of "some permanence" or other criteria that falls short of the required co-habitation period where there is no child.

The best advice to common-law couples is to seek professional advice and arrange their affairs so that in the event of death their rights are not subject to the various complexities of provincial rules that apply in the absence of planning. This will eliminate the uncertainty regarding rights on death that may arise if matters are left to default under provincial law. Where there is a desire to provide for one another, this can be done with good estate planning and Wills and beneficiary designations that reflect their wishes. Where there is a desire to limit rights, it may be possible to enter into a co-habitation agreement that sets out the rights of the parties and the limits of those rights. Again, this should not be left to provincial law by default. However, it is not usually permitted to contract out of support

obligations by contract, such as a co-habitation agreement or marriage contract, and this prohibition extends to contracting out of rights to dependants' relief on death.

3.2.10 Rights of a Spouse or Common-Law Partner to Division of Property under Family Law

Marriage creates a right to a division of family or matrimonial property on breakdown of the relationship in Canada. In most jurisdictions (Alberta, British Columbia and the Yukon being exceptions) this right extends to making a claim against the estate of a deceased spouse. Generally, claims against an estate will be in lieu of what the surviving spouse would receive under the Will. In some jurisdictions a common-law partner may also be entitled to property rights. Generally, the property subject to division is to be divided equally between the two parties with any unequal distribution giving rise to an "equalization" payment to be made to the party who has the shortfall. The right to matrimonial property has many characteristics that vary by province, including the following:

- the nature of property subject to division;
- the exclusions from property subject to division which may include:
  - property owned at marriage,
  - gifts during marriage,
  - inheritance during marriage,
  - the extent to which gifts or inheritance must be kept separate from other property in order to maintain their excluded status;
  - business assets; or
  - assets acquired after the date of separation;
- the circumstances in which an unequal division is possible under the legislation;
- whether conduct of the parties is a factor;
- special status of the family home;
- the ability to contract out of rights to share in a division of property; and
- whether a common-law spouse has any right to division of property.

Because of variation across Canada, couples should ensure that they obtain advice when moving from one jurisdiction to another. This is especially true of common-law couples as their rights, of all persons, vary most drastically from one province to another. In addition, the parent may need to consider the law in effect in the jurisdiction in which their children reside. If protection from spousal claims of a son- or daughter-in-law is very important, a trust may be the preferred strategy.

3.2.11 Change of Marital Status

Whenever marital status changes, there are legal consequences that affect estate planning. This is true when a relationship begins and ends. In the following paragraphs rights are referred to, but obligations are included along with rights as one spouse or partner may have rights that the other spouse or partner is required to honour.

In the case of death, the rights may be enforceable against the estate of the deceased spouse or partner. Rights on death may extend beyond the property of the estate to property held jointly by the deceased with third parties, and proceeds of insurance and registered plans that passed to third parties under a beneficiary designation, depending on the jurisdiction. For these reasons it is very important to ensure that the estate plan takes into account the rights of the surviving spouse or partner so that the planned distribution of wealth and the administration of the estate will not be disrupted by a claim. This is also true with respect to potential claims of others under dependants' relief legislation. Check the various scenarios below to determine the benefits and consequences for your client.

- **Engaged:** No immediate consequences, although in some jurisdictions, assets acquired "in contemplation" of marriage may be shareable upon separation, so assets acquired after the time of engagement may be shareable.
- **Co-habitation:** After a certain period of co-habitation (12 months for federal income tax and 2 or 3 years in most provinces), individuals may qualify as common-law spouses with rights granted in the particular jurisdiction. Rights, where granted, are not necessarily identical to those of formally married couples.
- **Registered or Civil Law Status:** Some jurisdictions provide the ability to formalize a marriage-like relationship that is short of a formal marriage by entering into a contract, or registering notice

of the relationship. In Quebec, those who enter into an agreement for a civil union are treated identically to married couples, however, their relationship can terminate on consent and they need not divorce to terminate the relationship. In Alberta, couples and even blood relations can enter into an agreement to be treated as Adult Interdependent Partners. Nova Scotia and Manitoba also offer a form of civilly recognized status.

- **Have a Child Together in a Relationship with Some Permanence:** A couple may acquire rights as a common-law couple once they have a child together, but these rights may not be as extensive as those of a common-law spouse who qualifies under the co-habitation period.
- **Marriage:** Upon marriage, rights arise as discussed above.
- **Separation:** In some jurisdictions there is a loss of some rights after a period of separation. For example in some jurisdictions where a common-law or married couple is separated and certain other conditions apply, there may be a loss of rights on intestacy. If the couple is co-habiting, all rights as a common-law spouse will cease after a prescribed period of separation. In certain jurisdictions separation has no effect on the rights of a married spouse under the Will or on intestacy. There may be limitation periods with respect to certain claims that lapse after a period of separation, such as a claim to family property. The rights of a spouse or common-law partner after separation or death vary considerably from one jurisdiction to another and the specific law in the jurisdiction must be referred to.
- **Divorce:** Rights as a spouse cease, with certain exceptions relating to time periods for rights to expire.
- **Death:** When a relationship ends with death, there are spousal rights against the estate of the deceased. These take the form of rights on intestacy, rights to dependants' relief in lieu of support, and rights to division of property. In Quebec, the heirs of the deceased may have a right to the property (called patrimony in Quebec) of the surviving partner.
- **Wills:** Except in Alberta, British Columbia and Quebec, marriage revokes a Will unless made in contemplation of the marriage. In some provinces a surviving spouse may elect to take under a Will

made before marriage. In Saskatchewan, co-habitation may revoke a Will once the period of co-habitation for recognizing common-law status is achieved and in Alberta a will is revoked upon entering into an adult interdependent relationship agreement. Generally, separation does not affect rights under a Will but this may vary by province. For example, in Manitoba, separation will disentitle common-law and married spouses under a Will in certain instances. Divorce generally results in the Will being interpreted as if the former spouse had pre-deceased the testator.

- **Beneficiary Designations:** Unlike Wills, these are not revoked or changed with changes in marital status. They must be reviewed whenever marital status changes. Terms in a separation agreement or divorce order are not sufficient to revoke a designation even if a person has agreed to do so. Many situations arise where a former spouse or partner becomes entitled to insurance or registered plans because the designation was not changed. In the case of registered plans this is particularly punitive (assuming it was not intended that the former spouse or partner receive the funds) because the proceeds will be paid in full to the named beneficiary but will be taxed in the terminal return of the deceased with the tax liability payable by the estate.

- **Jointly Held Property with a Right of Survivorship:** Changes in marital status will not affect the succession of property that is held with a right of survivorship to the surviving joint owners. For this reason, it is important to actually register a change in the ownership of such property if it is no longer intended that the spouse or partner or former spouse or former partner inherit the property.

- **Tax Consequences:** Income tax consequences also arise from a marriage or common-law relationship. The attribution rules and ability to have a tax-free transfer (rollover) of capital property and registered plans apply only to those who are recognized as married or common law under the *Income Tax Act* and cease on divorce. Twelve months co-habitation is required for common-law status and a common-law couple so recognized will be treated identically to married couples under income tax law. Only 90 days of separation is needed before common-law status ends under tax law. See section 6.2 in the *Wealth Planning* text.

- **Domestic Contracts, Marriage Contracts and Separation Agreements:** Many of the rights of married or common-law couples can be altered by entering into a contract or agreement. Such agreements may also set out rights that arise on the death of one of the parties. Generally, in order to be enforceable:
  - the agreements must be entered into voluntarily, without any threat or undue influence,
  - there must be full disclosure of financial information by both parties, and
  - independent legal advice must be received by both parties.

Certain matters may not be the subject of a contract or waiver. It is not possible to contract out of support payments for oneself or one's children. It may also not be possible to enforce an agreement that restricts access to the matrimonial home and it may be necessary to have a court order for exclusive possession.

3.2.12 Obligations on Death to Spouse and other Dependants re Dependants' Relief in Lieu of Support

Under provincial legislation, a surviving spouse (or common-law partner in most provinces), minor child, or other eligible person (collectively referred to as "dependants") may make a claim against an estate where the Will (or in some cases the distribution on intestacy) does not provide adequate support for such person. This right, in addition to the right of a surviving spouse (or common-law partner in some provinces) to a division of property, limits testamentary freedom. Short of these obligations, and except for conditions void for public policy reasons, a testator may dispose of his or her estate as he or she wishes.

In British Columbia, there is no legislation providing for dependants' relief. Instead there is legislation that permits the court to vary the terms of a Will. This legislation has been used for broader purposes that provide dependants with a distribution in lieu of adequate support. It has been extended to redistribute an estate according to what the courts have perceived as a moral obligation the deceased owed to family members. Generally, once a spouse has been provided for adequately, children are considered to be entitled to receive a share of their parents' estates, and this share may be required to be equal among children notwithstanding the wishes of the testator. The concept of moral obligation is gaining some recognition in other Canadian jurisdictions, but has not reached the status it is accorded in British Columbia under their Wills variation legislation.

3.2.13 Unjust Enrichment and Other Equitable Remedies

It may be possible for a claim to be made against an estate by a family member under the doctrines of resulting trust, constructive trust, or quantum meruit. These are non-statutory "equitable remedies" developed over time in law and arise in unique circumstances. Equitable remedies are not available to spouses in all jurisdictions. However, they may be the remedy of last resort where other rights are not available. For example, where a common-law spouse has no rights to division of property under provincial law, an equitable remedy may be available. A constructive trust is generally available where there has been unjust enrichment. Quantum meruit is available where services have been performed without compensation.

3.2.14 Second Marriage or So-Called "Blended Families"

Second marriages create potential conflict among family members who are not related to each other but are related to the deceased. The new spouse, children of a previous relationship of the new spouse, children of the previous marriage of the testator, children of the second marriage, and the former spouse all have competing interests and may well have a long history of resentments against one another. These resentments are often not articulated openly in order to keep the peace while the parent is alive, but arise with surprising vigor when the parent, sometimes referred to as the "moral authority," passes away. One very common mistake in estate planning is to over-estimate the degree to which these individuals may get along once the individual linking them together dies.

For example, the children may tolerate the second spouse for the sake of pleasing the parent, but when the parent dies the loyalty to the other parent may be converted into conflict with the surviving second spouse and his or her own children from a previous relationship.

Estate planning objectives unique to second marriages may include the following:

- to provide for the surviving spouse,
- to preserve capital for the children of the first marriage,
- to minimize conflict between the spouse and the children,

- to defer or minimize taxes by using the spousal rollover for capital property and registered plans, and
- to provide an immediate distribution to the children so they do not have to wait until the surviving second spouse dies, especially where the second spouse is significantly younger than the testator.

These are not easy objectives to achieve in combination with each other. In some cases life insurance can be effective, either to provide for the surviving spouse or to fund an immediate distribution to children. It may be more tax effective to use insurance to fund the children's inheritance so that the spousal rollover will be available for the inheritance by the spouse. However, insurance for the surviving spouse can provide a more secure way of providing for the spouse and the amount will not fluctuate. A spousal trust can be useful to have the rollover and preserve assets for the children, but the choice of trustee is key to how this will operate. If the children and the spouse are trustees together, this could be unworkable as there is a conflict of interest and there is often built-in conflict already even without requiring these parties to act together as trustees. See 8.5.2 in the *Wealth Planning* text.

Unfortunately, tax laws do not permit a tax-free rollover of a registered plan to a spousal trust. So it is not possible to preserve the capital of an RRSP or RRIF for the children of a previous relationship if the testator wants the rollover to go to the spouse. See 8.5.2.4 in the *Wealth Planning* text for a discussion about registered plans in a second marriage situation. With respect to locked-in registered plans a surviving spouse may be entitled to such plans automatically, and if it is desired to leave something to children this must be carefully examined.

Entering into a marriage contract may be especially important in the event of a second marriage, particularly with respect to rights to division of property and rights to own and occupy the matrimonial home on breakdown of the relationship or death. It may be possible to enter into a limited agreement that deals only with claims to property on death without dealing with rights if the couple separates or divorces.

3.2.15 Vacation Properties

The succession of the family vacation property can be one of the most important estate planning objectives for some families. These properties pose a variety of problems for the estate plan.

- Multiple family members and sometimes multiple generations use the property, and it may be difficult to anticipate or control how future owners might co-operate regarding use of the property and the cost of maintenance, repairs, and improvements. Dividing the property equally among the children may result in conflict especially where children and their families do not necessarily make equal use of the property, or there is a pre-existing history of conflict.
- The property usually cannot be divided. It may be too small. Or the land may not be severable, but may have several buildings and other features attached to it, some of which are used only by some family members, and others (such as dock and boathouse) that may be used by everyone. Or the land may be in severed adjacent pieces, but division among family members may not be practical because of the existing use of the property.
- The property often has sentimental value and there is an emotional attachment to it by multiple family members. The "heirloom" value often exceeds the dollar value many times over.
- Sometimes the less financially well-off family members use the property more often, or to the exclusion of other family members, but they may not be able to "afford" to use all their inheritance to purchase the property from the estate.
- Parents may create elaborate plans for the property without fully appreciating how their children might use the property once they have passed away. Children often enjoy the use of the property as long as their parents are the hosts, but they may not want to shoulder the responsibilities that owning and maintaining such a property involve. Often these views are not shared with the parents for fear of offending them, either by contemplating the parents' demise, or by disappointing the parent who wants the property to stay in the family.
- The tax liability arising on the deemed disposition of the property can be difficult to fund especially if the value of the property is a significant portion of the value of the estate as a whole. The disproportionate value of the property could also lead to distribution

problems if one child is to be given the property as part of his or her inheritance but the overall distribution is to be equal in value.

- If a child or other family member receives direct ownership of the property, either as sole or joint owner, the property may become subject to family law claims of that owner for a division of property.

For tax purposes the property may be eligible for the principal residence exemption notwithstanding its recreational use. The term “principal” in the definition is a misnomer, and refers to the fact that the property must be used principally *as a residence* rather than it being the main residence over other residences owned by the taxpayer. However, typically the exemption will be used for the family home, or for whichever property has the highest gain per year during the holding period.

If the property is outside Canada the principal residence exemption is available, but if the gain is taxable in the foreign country, using the exemption might “waste” the foreign tax credit available. If the property is in the U.S. it may be subject to U.S. estate and gift tax.

Strategies for leaving the vacation property to the children generally involve one of the scenarios described below.

- The parent makes a specific gift to the child who most wants or uses the property, or grants that child an option to purchase at fair market value. Sometimes this plan is extended to more than one child with the remaining children not receiving any interest in the property, or to successive children.
- A specific gift is established in the Will to all the children in equal or unequal shares. In such a case the children will own the property jointly as tenants in common, unless they instruct the executors otherwise when the distribution is made.
- Where there is a specific gift, the value of the property may be (or may not be depending on the parent’s wishes) deducted from that child’s share by using a hotchpot clause. The value for the adjustment can be fixed at a specific dollar amount, or could be the fair market value or a discounted value at the time of death.
- In many cases a specific gift is not recommended and can lead to animosity between the beneficiaries. A better option may be for

the Will to say nothing, permitting the property to fall into residue thereby leaving the executors to decide how it will be treated – i.e., whether sold or distributed in kind, and to whom it will be transferred. See case study 15.4.2 of the *Wealth Planning* text for an illustration of the planning that can be done to ensure there is sufficient liquidity to allow a beneficiary to notionally "buy" a property from the estate, if they would like to receive the vacation property as part of their share of the estate.

- The property is transferred to a trust (or very infrequently to a corporation) to manage use by multiple beneficiaries and co-ordinate management of the property.

The strategies for succession of the vacation property are discussed in considerable detail in chapter 15 of the *Wealth Planning* text.

3.2.16 Case Studies

Wealth Planning text at 2.8.1 – Single, No Children

Wealth Planning text at 2.8.2 – Single, With Children
Note that trusts in a Will for insurance proceeds must be carefully drafted to avoid the funds being included in the estate where they are subject to probate fees and the claims of creditors. Generally, the trustees must be actually named rather than referred to by their office as trustees or executors of the estate. For example, the insurance trust appointment should be drafted as "my brother Gary Black and my sister Sarah Singh" rather than appointing "my Estate Trustees" even where these are the same persons. This is the result of the *Carlisle* decision.

Wealth Planning text at 3.10.1 – Living Common-Law, Jurisdiction Generally Does Not Recognize Status

Wealth Planning text at 3.10.2 – Living Common-Law, Jurisdiction Generally Recognizes Status

Wealth Planning text at 4.8.1 – Engaged, One Spouse Owns a Home
Several jurisdictions have special rules relating to division and occupation of the matrimonial home. It is important for married couples or those contemplating marriage, or common-law couples who may be subject to identical or similar rules

to obtain advice where a home is owned or purchased to ensure the appropriate result in the event the relationship ends, or one party dies.

Wealth Planning text at 4.8.2 – Engaged, One Spouse Owns a Business

Property subject to division under family law may or may not include business assets depending on the jurisdiction. In jurisdictions where business assets are subject to division, consideration may be given to a marriage contract or co-habitation agreement.

Wealth Planning text at 5.8.1– Married, With Children, No Will

Wealth Planning text at 6.8.1 – Separated, Living Common-Law, No Children

The New Brunswick law that applies to Iris and Andrew will have different consequences if they are in different jurisdictions. Look also at the "Jurisdictional Differences" in the *Wealth Planning* text to compare how this fact situation would be treated differently. Review carefully the discussion in 6.8.1.1 and in particular the consequences in your jurisdiction.

Wealth Planning text at 6.8.2 – Separated, Married, No Children

Wealth Planning text at 6.8.3 – Separated, Living Common-Law, With Children

Review this case study from Alberta and consider any differences in your province of residence.

Wealth Planning text at 6.8.4 – Separated, Married, With Children

Wealth Planning text at 7.8 – Case Studies on Divorce

Wealth Planning text at 8.8.1 – Blended Family, Living Common-Law, No Will – See Study Unit Two

Wealth Planning text at 9.8.1 – Widowed, With Minor Children

Wealth Planning text at 9.8.2 – Widowed, With Adult Children

This is a good example of post-mortem tax planning where it is advantageous not to make full use of the spousal rollovers available on death. If Giselle wants to solve the succession problem with respect to the registered plan if one of her children pre-deceases her, she could use a hotchpot clause in the Will to ensure children of a pre-deceased child benefit equally with a surviving child. However, there would have to be sufficient assets in the estate to fund the adjustment.

Wealth Planning text at 10.8.1 – Married, With Minor Children – See Study Unit Two

Wealth Planning text at 10.8.2 – Married, With Adult Children – See Study Unit Two

Wealth Planning text at 10.8.3 – Establishing a Formal Trust for a Child
This describes establishing an *inter vivos* trust. The structure avoids the attribution rules that are not relevant in setting up a testamentary trust.

Wealth Planning text at 10.8.4 – Equalizing an Estate for Children

Wealth Planning text at 11.8.1 – Leaving Money to Grandchildren in a Will

Wealth Planning text at 12.6.1 – Disabled Child, Henson Trust – See Study Unit Two

Wealth Planning text at 13.8.1 – Elderly Parents with Adult Children – See Study Unit Two

3.3 SUMMARY OF KEY ISSUES

Estate planning is all about families. Family members will have expectations about what they will receive from a parent or other family member's estate, and in many cases family members will have a legally enforceable claim against the estate if sufficient provision is not made for them. Individuals usually want the bulk of their estate to pass to family members. If the balance between what an individual wants to leave to the family on death, and the family's expectations or rights is not made, litigation may result. Even worse, family relationships may be irreparably harmed and the legacy of the deceased individual may be one of bitterness rather than fond memories and an orderly passing of wealth.

Many factors relating to the family will affect the estate plan.

- Who are the family members?
- Are there siblings, nieces and nephews?
- Are parents living?
- What is the individual's marital status?
- How many children are there?
- Are any persons dependent on the client?
- To whom are obligations owed on death?

- Are there any special needs beneficiaries?
- Are there any beneficiaries who need protection?
- Who does the client want to benefit?
- Who does the client want to exclude?
- Have there been multiple marriages or relationships?
- Are there children from several relationships?
- How will family members get along?
- Who is appropriate to manage the estate?
- Who is appropriate to make decisions about property or personal or health care in the event of incapacity?
- How will the client's tax saving objectives be blended with the plans for distribution to family members?

The answers to these questions may determine in large part the details of the estate plan.

The relationship between family members is also important if they are required to co-operate in the administration of the estate or if resentments among family that spark disputes are to be avoided. It is also important to examine the relationship of the client to his or her family members to determine his or her objectives and philosophy about transfer of wealth. For example, does the client think it should be as simple as possible and every beneficiary should receive their inheritance as soon as possible? Or is the client determined to extend terms beyond death by creating trusts that control the property and keep it out of the hands of the beneficiary for a period of time after death?

It is rare that an individual has no family members who play a part in the estate plan. Even if the individual wants to disinherit family members completely, this may be subject to some restrictions if there is a potential claim for dependants' relief, division of property under family law or a claim for an equitable remedy.

3.4 TERMINOLOGY

Inter Vivos: During lifetime. Refers often to gifts made during lifetime or trusts created during lifetime as opposed to those on death.

Proponent: the person who is supporting the validity of a position or document. In reference to a Will, it refers to the party seeking to have a Will probated, and who is asking the court to formally approve of the Will.

Quantum Meruit: An equitable remedy that awards compensation for the value of services provided gratuitously.

REVIEW QUESTIONS AND ANSWERS

Questions

1. Explain why the following statements are true or false:

   (a) Married couples who have everything in joint names with a right of survivorship and have designated each other as beneficiaries do not need Wills because everything will pass automatically to the surviving spouse.

   (b) The advisor should encourage parents to treat their children equally in their Wills.

   (c) In discussing how a client plans to divide and distribute his or her estate in the Will, the advisor should be asking open-ended questions.

   (d) Minor children should be provided for in a Will by creating a trust for their inheritance.

   (e) A spousal trust can be used to prevent the surviving spouse from making a claim for division of property under family law.

   (f) Claims for dependants' relief can be the subject of a marriage contract such that the surviving spouse can relinquish his or her right to make a claim against the estate.

   (g) Making a minor child the beneficiary of a registered plan is a good strategy as the proceeds need not be taxed in the terminal return, and the proceeds of the plan can be invested in an annuity payable to age 18 and the tax treatment deferred until the annuity payments are made.

   (h) Common-law couples are now recognized legally in all provinces in Canada and are accorded the same rights and privileges as married partners.

2. Suggest five family situations that might make the appointment of a trust company (i.e., a "corporate executor") a wise choice.

3. Explain why estate planning is particularly important for common-law couples. What is required to ensure the surviving partner inherits the wealth of the first to die? How might this differ if the partners wish to limit the right to an inheritance? Your answer should address documents required and title to property.

4. How should the terms of a testamentary spouse trust be set in order to:

   (a) achieve the spousal rollover,

   (b) protect the children's inheritance after the death of the spouse, and

   (c) achieve maximum potential income tax savings through income splitting for each of the children and their families after the death of the surviving spouse?

5. In what circumstances would it be appropriate to make a dependant's relief claim against an estate? Give at least two examples.

6. Compare the estate planning objectives and issues of a married couple with young children to those of a married couple who are 65 or older with adult children and grandchildren with respect to the following matters:

   (a) choice of executor,

   (b) support obligations,

   (c) concerns about remarriage of surviving partner, and

   (d) protection of beneficiaries (other than spouse) against family law claims.

Answers

1. True or False and Explanations.

   (a) False. There will be intestacy if both spouses die in a common accident. In addition, certain unanticipated amounts could be payable to the estate (e.g., insurance from an automobile accident claim).

(b) False. The advisor should avoid imposing his or her views on the client and permit the client to consider his or her own wishes. The advisor may advise regarding the consequences of the client's wishes but permit the client to make an informed choice regarding his or her estate.

(c) True. As above. Assumptions should not be made and the discussion with the client should always be designed to encourage the client to explore his or her own wishes. The advisor should never say –"you probably want all your children to inherit your estate." However, if asked by the client, the advisor might say "most parents leave their property to their children in their Wills in equal shares but you are not required to do so, short of providing for dependants." Open-ended questions are particularly important if the client is prone to be easily influenced by others. If the client does not know how to decide a particular issue, the advisor may suggest options along with advantages and disadvantages to each alternative. If the client cannot decide, the advisor can move on to other issues and allow the client time to make a decision, which might be at a later date after consultation with other family members or persons whom the client looks to for advice (assuming there is no undue influence).

(d) True. This will avoid the public guardian or other public official from gaining control of the child's property. In addition, the trust can extend beyond age 18 so distributions are delayed until the child is old enough to be financially responsible.

(e) False. A claim for division of property on death, where available, overrides the Will.

(f) False. It is not possible to contract out of support obligations or dependants' relief.

(g) False. There are many problems with minor's being beneficiaries of registered plans, including the requirement to appoint a guardian for property to manage such funds once received.

(h) False. Common-law spouses are not recognized at all in some jurisdictions and are only recognized for some purposes in others.

2. Family situations that might make the appointment of a trust company (i.e., a "corporate executor") a wise choice are any of the following:

   (a) There is a second marriage and an on-going testamentary trust is created to provide for the second spouse, but ensure children from the first marriage benefit after the death of the spouse.

   (b) There is a trust for a disabled child for life, requiring a trustee over a long period of time.

   (c) No family member, or other suitable individual, is resident within the jurisdiction (if only available persons are non-residents of Canada this is especially important).

   (d) Children do not get along.

   (e) The testator is single or widowed with no children, or other suitable person to appoint.

   (f) The testator is separated but financial settlement relating to property has not yet been reached and it is not desirable to have children handle this as executors.

   (g) There is a testamentary spousal trust because the other spouse is incapable, or has poor financial management skills.

   (h) Wherever a testamentary "protection" trust is needed (such as a spendthrift trust, creditor protection trust) for a child, and it is not desirable to have the other children be their "brother's keeper."

3. The law across Canada varies from one province (or territory) to another and the rights of a surviving partner can be unpredictable. Failure to plan adequately, or at all, can result in litigation if the surviving partner is not adequately provided for, especially if the provincial rules do not otherwise provide for division of property, dependant's relief, and/or rights on intestacy. Even where rights exist, other family members may challenge the right of a common-law spouse, and it is not always clear whether the particular partner qualifies as a common-law spouse for the purposes of the benefits under provincial law. Planning by both partners in a common-law relationship can ensure that the succession of property on death is

appropriate. If the partners in the relationship want to ensure the surviving partner inherits, well drafted Wills, jointly held property, and beneficiary designations can achieve this. If the partners wish not to have each other as beneficiaries, or wish to limit the entitlement of the other spouse, it is best to combine estate planning with a binding co-habitation agreement, and property should be held separately – not jointly with a right of survivorship. (Note that such agreements are not effective to waive rights to support, including dependants' relief in most jurisdictions, although the Courts may take them into consideration.).

4. Terms of a testamentary spouse trust:

   (a) Spousal Rollover: The trust must be for the sole benefit of the surviving spouse during the lifetime of the surviving spouse. All the income must be payable to the surviving spouse and no one other than the surviving spouse may be entitled to the capital.

   (b) Protect Children's Inheritance After the Death of the Surviving Spouse: The children should be the beneficiaries of the spouse trust after the death of the spouse/beneficiary. If the testator is concerned that the assets of the trust will be significantly reduced during lifetime of the surviving spouse, a number of options are available. There could be a restriction on the access to the capital of the trust. Either payments of capital to the spouse could be prohibited, or there could be a limited discretionary power for the trustees to encroach on capital. For example, encroachments on capital could be limited to maintenance and support, or the amount to be received by the spouse each year could be all the income, plus any amount required from the capital of the trust to achieve a certain fixed minimum dollar distribution each year. Restrictions on payments of capital could be challenged by the surviving spouse if it is clear that the income from the trust will not be sufficient to meet the support obligations of the deceased spouse to the surviving spouse. If the power to encroach on capital is unlimited, the testator could appoint an arm's length impartial trustee such as a trust company, to ensure that such encroachments do not jeopardize the children's entitlement to the remaining assets on the death of the surviving spouse.

(c) Achieve Maximum Potential Income Splitting/Tax Savings for Children and their Families: After the death of the surviving spouse, the funds in the spousal trust can be divided into separate trusts for each child and his or her family. The trusts should be discretionary as to payments of income, capital, and beneficiaries to achieve flexibility to maximize the use of the marginal rates of the children and their children. Beneficiaries can include the spouse of the child and/or other spouses of grandchildren or more remote issue.

5. A dependant's relief claim might be appropriate wherever a person who qualifies as a dependant in relation to the deceased (as defined under the provincial legislation) has not been adequately provided for by the deceased. For example, if a minor child of the deceased is not provided for in the Will, a claim might be made on behalf of the child – this might be particularly appropriate, for example, where the other parent cannot otherwise provide support. Similarly, a surviving spouse who is disinherited, or who is left only a portion of the estate might make a claim.

6. Comparison of the estate planning objectives and issues of a married couple with young children to those of a married couple who are 65 or older with older children and grandchildren.

	Married Couple with Young Children	**Married Couple who are 65 or Older with Adult Children and Grandchildren**
(a) Choice of Executor	Usually can appoint the spouse, with an alternate who is a cohort (i.e., a brother or sister), since at least one of these is likely to outlive them. Children are minors, or too young for the responsibility.	Spouse may be elderly or pass away first, so alternate or co-executor is important. The executor needs to outlive them, so siblings or friends usually not best – rather adult children if appropriate, otherwise a trust company.

	Married Couple with Young Children	Married Couple who are 65 or Older with Adult Children and Grandchildren
(b) Support Obligations	Support obligations to other spouse and children must be considered. Insurance should be considered to provide income replacement for spouse and children, and fund post-secondary education.	Have obligations to other spouse. On death of both spouses, usually have none, so subject to "moral obligations" that some provinces (notably B.C.) have imposed, they are free to dispose of estate to any beneficiary in any manner. If there are dependants (such as a dependant grandchild, or disabled child) these must be provided for – joint last to die insurance could be considered if they qualify, and it is available at reasonable rates.
(c) Concerns about Remarriage of Surviving Partner	This is a concern because of the age of the surviving spouse, especially where the survivor may also have children with a new partner. In some cases a spousal trust could be considered to protect the inheritance of the children of the marriage, but usually only if the estate is large, or the concern is great. Any trust for a surviving spouse might be challenged because of support obligations to the spouse. Rights to encroach on capital can be restricted or prohibited.	This is usually not a major concern, although awareness of this issue and its relevance in estate planning is growing. As life expectancy is growing, more and more senior widows and widowers may remarry, which may revoke any existing Will (depending on the jurisdiction). A spousal trust may be used, although the concern about support obligations must be addressed. Any trust for a surviving spouse might be challenged because of support obligations to the spouse. Rights to encroach on capital can be restricted or prohibited.

	Married Couple with Young Children	Married Couple who are 65 or Older with Adult Children and Grandchildren
(d) Protection of Beneficiaries (other than spouse) Against Family Law Claims	Children are usually too young for this to be an issue.	Often a concern with respect to spouses of adult children particularly if there has already been a marriage breakdown in the family, or the couple strongly disapproves of a child's spouse. Trusts can be used to protect the inheritance. The planning should also take into consideration any protection of inheritance under provincial law that varies under each jurisdiction and often can be lost, such as where funds are mixed.

STUDY UNIT FOUR

BUSINESS ESTATE PLANNING

Knowledge Objectives

Skills Objectives

Topics Covered

Related Textbook Readings

4.1 INTRODUCTION 4-4

4.2 BUSINESS ESTATE PLANNING 4-4

4.2.1 Unique Characteristics of the Owner-Manager 4-5
4.2.2 Unique Planning Requirements 4-7
4.2.3 Taxation of Private Corporations and their Shareholders 4-8
4.2.4 Creditor Protection 4-10
4.2.5 Incapacity Planning 4-11
4.2.6 Using a Spousal Rollover and a Spousal Trust 4-12
4.2.7 Leaving the Business to Family Members 4-13
4.2.8 Providing for the Business in the Will 4-14
4.2.9 Ownership of the Family Business 4-15
4.2.10 Estate Freeze 4-16
4.2.11 Buy-Sell Arrangements After Death of a Shareholder 4-19
4.2.12 Cross Purchase 4-19
4.2.13 Share Redemption 4-19
4.2.14 Determining the Method of Structuring the Buy Sell 4-21

4.3 COMMENTARY ON ASSIGNED READINGS AND CASE STUDIES 4-21

4.4 SUMMARY OF KEY ISSUES 4-24

4.5 TERMINOLOGY 4-26

REVIEW QUESTIONS AND ANSWERS 4-27

Study Unit Four

Business Estate Planning

Learning Objectives

Knowledge Objectives

Upon completion of this unit the student will:

- Appreciate how estate plans are tailored to business owners' situations
- Understand the planning needs and opportunities for owner-managers
- Understand post-mortem tax planning strategies and when they are appropriate

Skills Objectives

Upon completion the student will, in relation to the topics listed below, be able to:

- Analyze the client's business structure with a view to determining the extent of his or her interest and ways in which that interest can be maintained for wealth preservation and estate planning purposes
- Examine the applicability of buy-sell agreements in supporting the client's plans
- Illustrate the benefits of a buy-sell agreement and show alternative structures
- Identify and explain key planning strategies for the owner-manager
- Explain an estate freeze and identify when it is appropriate
- Describe the importance of business succession
- Understand how to maximize the use of the lifetime capital gains exemption

Topics Covered

Planning for the Business Owner

- Unique Characteristics
- Tax Planning Strategies
- Estate Distributions
- Business Succession
- Estate Freeze
- Client Profile

Buy-Sell Arrangements

- Methods
- Criss-Cross
- Promissory Note
- Redemption and Purchase
- Hybrid

Related Textbook Readings

Estate Planning with Life Insurance
Glenn R. Stephens, LL.B.

Chapter 2	Taxation and Product Overview
Chapter 3	Life Insurance and the Need for Estate Liquidity
Chapter 4	Introduction to Corporate-Owned Life Insurance
Chapter 5	Family Business Succession
Chapter 6	Using Life Insurance to Fund Buy/Sell Agreements

Wealth Planning Strategies for Canadians
Christine Van Cauwenberghe, B.Comm. (Hons), LL.B., CFP, TEP

Chapter 16	Business Owners

4.1 INTRODUCTION

Business owners have unique characteristics and unique estate planning needs. Many of the issues that arise for "owner-managers" (as they are sometimes called) are encountered by other individuals. However, owner-managers have a combination of issues that makes their planning particularly challenging. Their needs tend to be multi-faceted, crossing many disciplines. They may require a variety of advisory services, including accounting, taxation, family law, human resources, business valuation, mediation, insurance, and investment management. Business succession and the need for liquidity are often assumed to be the prime estate planning needs. However, these two issues, while of essential importance, may only be the tip of the iceberg in terms of recognizing the complex issues. In addition, because family members are often involved in the business there is a blending of family relationships with business matters and this can cause significant emotional overtones that affect the planning process.

4.2 BUSINESS ESTATE PLANNING

The purpose of this Study Unit is to focus on the business owner and examine planning issues and strategies from the perspective of the owner-manager's circumstances. The ownership of a business is the unifying factor in all the topics covered in this Study Unit. The problem of who will manage the family business when the founder retires or dies, the strategies to achieve this on a tax-effective basis, and the method to pay the tax on the transfer of the business are the three main challenges. Add to this the complexity of the owner-manager's personal and financial situation, and the advisor has a particularly challenging mix of issues, opportunities, and strategies to identify, understand, evaluate, recommend, and implement. This unit will provide an intermediate-level examination of estate planning for the owner-manager building on the material in the other Study Units and on the student's own professional experience and previous studies.

Some of the topics in this Study Unit overlap others. Chapter 3 of the *Life Insurance* text deals with, among other things, taxation on death and probate fee planning. These sections of Chapter 3 can be reviewed here, but should primarily be reviewed in conjunction with Study Unit Two: Personal Estate Planning. Chapters 3 and 4 of the *Life Insurance* text are also included in Study Unit Five: Estate Planning with Life Insurance and are discussed in more detail there.

Chapter 4 in the *Life Insurance* text, is also covered in Study Unit Five. It is not expected that the student will master the solutions to the income tax problems created when a life insurance policy is held by an operating company and the policy needs to be transferred out of the company because of an impending sale. Rather, it is important to understand how to avoid these tax problems by ensuring that the owner of the life insurance policy is not the operating company.

4.2.1 Unique Characteristics of the Owner-Manager

Not everyone has the kind of ambition and independence it takes to start their own business. Those who do and who succeed share some common attributes. These often include a fierce drive to succeed, a disciplined work ethic, and a single-mindedness of purpose. These attributes contribute to the success of the business. They also have side effects that impact estate planning.

The owner-manager may be so focused on the business to the exclusion of everything else that personal and family relationships suffer. This may result in failed marriages and children who resent their parents and the business. Owner-managers are often in a second marriage and may be particularly sensitive to protecting assets for themselves and their children from family law claims.

The wealth that success brings results in a complex financial situation, both within the business and personally. Owner-managers may not have much time or interest in doing personal financial or estate planning. While they might be very astute at managing money in the business, when it comes to managing their personal financial affairs, this may not receive the same attention.

Unfortunately, wealth also attracts its own problems. Many owner-managers experience lawsuits with business partners and family members over a variety of issues. These often include the ownership, structure, and control of the business, and may occur during lifetime or on the death of the owner-manager. A shareholder agreement may reduce the risk of litigation, but negotiating a shareholder agreement and keeping it up to date is often a neglected task along with the estate plan.

Motivating an owner-manager to do estate planning is not always easy. More than one very wealthy owner-manager has died without an up-to-date Will or any Will at all. And this may compound problems if no succession plan is in place. Though often reluctant to address their own estate planning needs, once

owner-managers focus on a task, they have a sense of urgency about completion. Because estate planning tends to be so complex for owner-managers, they may lose patience and abandon the process before the plan is complete. The advisor can play an important role in working with an owner-manager by convincing them to address their estate planning needs and providing appropriate strategies and recommendations.

One strong motivator for the owner-manager is income tax savings. They may not be motivated by the prospect of their own mortality, but the fear of overpaying taxes on death can often direct their attention to estate planning.

The owner-manager who builds a business from scratch initially will control all aspects of the business. It can be difficult to let go of control as the business grows and delegate to management. This can also make it difficult to develop and implement a business succession plan. If family members or existing management are not being given responsibility that will enable them to run the business in future, the transfer of the business may not operate smoothly. Costly mistakes may be made and there may be an interruption in business operations. If customers, suppliers, lenders, partners and other business relationships essential to the business are personal to the owner-manager, the business may falter when the owner-manager is no longer at the helm.

The owner-manager may put a great deal of trust in one or more advisors whose relationship is long-standing. Sometimes the needs of the owner-manager exceed the expertise of the advisor as the business grows and the business becomes more complex. They also often have practices that are more general in their professional fields, rather than the specific tax and legal expertise the owner-manager requires for a complex estate plan. However, these advisors must be part of the team if the estate plan is ever to be completed. These “trusted advisors” very likely know the individual, know the family, have inside information that may never be shared with an untested or new advisor, and may have a better understanding of the facts than the owner-manager him- or herself. Most importantly, the owner-manager will often make no move without their concurrence. Tax advisors, lawyers, and other professionals who specialize in corporate reorganizations and estate planning for owner-managers are best positioned to work as the “specialists” who work with the owner-manager and his or her family and existing advisors to advise with respect to their particular area of expertise. This approach better wins the goodwill of existing advisors who otherwise may be uncooperative if

the relationship with their client appears under threat. Generally, owner-managers remain fiercely loyal to those who have gained their hard-earned trust.

Preparing a business for succession is a whole study in itself that will not be included here. However, it is important to appreciate that this is a process that the owner-manager can master or ignore. If mastered, the business may have a better outlook under the guidance of the founder; new management and ownership will have been transferred in an orderly fashion. If ignored, the future success of the business may be uncertain and the value of the enterprise built up during the lifetime of the owner-manager may dissipate.

4.2.2 Unique Planning Requirements

A number of planning issues are unique to the owner-manager, including the following:

- determining how the business will be owned, operated, and controlled after the retirement or death of the owner-manager;
- resolving how income tax payable on death with respect to the business will be calculated and funded;
- establishing how the needs of all beneficiaries will be met;
- finding solutions to solve the problems created where there is an over-concentration of wealth in the business;
- dealing with the growth and complexity that a successful business brings;
- understanding that wealth results in additional taxes and attracts claims and litigation; and
- recognizing that needs may surpass the existing advisors' expertize.

One key question is whether family members will be involved in the succession plan. If children are already working in the business and have taken on leadership roles, the owner-manager may be confident that there is one or more heir apparent to the business. In other cases there may be an expectation that children will want to own and run the business. However, a reality check may be wise – what the parent wants and what children want do not always align. There are family business consultants who specialize in facilitating discussions relating

to family succession plans. They can be very helpful in ensuring that there is intergenerational agreement and mutual understanding about the future of the business. If parents and children do not have similar visions of the ownership or direction of the business, it is better to find out early in the process rather than have an intricate plan fail when the owner-manager dies because beneficiaries are not on side. There is often sibling rivalry over future control and ownership of the business as well. While the estate planner is not a therapist, the antennae should be up to recognize clues for potential future conflict, and the plan should be designed to minimize as much as possible the opportunity for conflict to sabotage the administration of the estate and the succession of the business.

In examining the succession of the business the questions below are very relevant to the estate plan.

- Will the business pass to family members or be sold to third parties?
- How will the transfer of control be managed?
- How will the value of the business be shared with the family?
- What is the value of the business in relation to other estate assets?

The issue of succession is key to the estate plan. The *Life Insurance* text aptly divides succession of the business into two categories: the business will pass to the next generation; the business will pass to non-family shareholders or partners who are already in the business. Chapter 5 of the *Life Insurance* text deals with the former, and Chapter 6 with the latter, however the material in each chapter could apply in some circumstances to either type of succession.

4.2.3 Taxation of Private Corporations and their Shareholders

The taxation of private corporations and their shareholders is extremely complex and details are not part of this material or the course. It is expected that the student will have some background in this area, and some self-study will be required if this is not the case. Chapters 2 and 3 of the *Life Insurance* text, and Chapter 21 of the *Wealth Planning* text offer a good basic review. The issues for owner-managers relating to personal financial and estate planning cannot be fully appreciated without an understanding of the principles and rules relating to private corporations and their shareholders. At least a basic understanding of the following will be helpful to this end:

- the small business deduction,
- the capital gains exemption,
- the capital dividend account,
- rollovers available on transfers of property to corporations,
- rollovers available on corporate reorganizations,
- estate freeze,
- crystallization,
- purification,
- tax treatment of investment income within a private corporation and upon distribution to shareholders, and
- the use of the loss carry back rule for capital losses realized in the first year of the estate on redemption of shares.

A general understanding will be sufficient for this course, and students are not expected to be familiar with the details of these rules or concepts except to the extent they are included in the required reading of the Study Unit or any of the case studies.

The student should also be aware that almost anything published relating to income tax is subject to change, and is probably out of date already if it contains specific tax rates that are constantly in a state of flux.

For business owners of private corporations, maximizing the utilization of the lifetime capital gains exemption is often a major tax objective. Students should be familiar with this exemption, and have a general understanding of the rules relating to the definition of qualifying shares – that is, shares of a qualified small business corporation, and the methods to utilize the exemption in respect of such shares. Using the spousal rollover to defer tax on the business until the death of the surviving spouse, and estate freezes should also be well understood.

Post-mortem tax planning for deceased shareholders of private corporations is complex in the extreme. Tax planning relating to the use of insurance and the capital dividend to fund, purchase or redeem private corporation shares is covered in the *Life Insurance* text in some detail. Students should be aware that neither

of the required reading texts provides a complete analysis of the tax planning available for the estates of deceased shareholders or owner-managers.

4.2.4 Creditor Protection

Creditor protection is covered in Study Unit Two. It is an important element of planning for owner-managers, and is specifically discussed in the *Wealth Planning* text at 16.1.2. Incorporation will protect the shareholder from personal liability from the creditors of the corporation in theory. In reality, business owners may be required to provide personal guarantees to lenders or others as a condition of doing business, and a business owner will often be added to a lawsuit in his or her personal capacity as a matter of course in the litigation. In addition, business owners are often exposed to claims from outside the business itself by disgruntled business partners, family members, and spouses.

It is common for business owners to arrange to have personal assets such as the family home and investments held in the name of the spouse. This can have unhappy repercussions if there is a marriage breakdown. Under most provincial family law regimes each spouse is entitled to a one half share of family property. However, if the non-owner-manager spouse holds all the personal assets this may be very inconvenient during the period before the division of property can be negotiated or litigated. If the relationship is common law, there may be no rights to divisions of property in the province. Other provincial variations include whether business assets are subject to division, and the treatment of property acquired before marriage or by gift or inheritance. Not all provinces include business assets in property subject to division. The benefit of isolating assets in the name of the spouse from claims of creditors must always be measured against family law issues and the law in the particular province.

Not every province permits division of property on death – notably Alberta, British Columbia and the Yukon provide no division of property on death for the benefit of a surviving spouse (although there is dependants' relief or Wills variation legislation in every province and territory). This could work to the disadvantage of the business owner if there is a transfer of non-business assets by the owner to the spouse, who subsequently dies without making the owner-manager the beneficiary of those assets. Spouses in this situation should update their Wills to ensure the plan operates as intended.

A marriage contract can alter the rights and obligations between married or common-law couples with respect to division of property on marriage breakdown or death. However, it is not possible to contract out of rights to support or dependants' relief. It is also questionable whether it is possible to contract out of equitable remedies. Where marriage contracts or other agreements are entered into (i.e., co-habitation agreements, separation agreements, and the like) they may be set aside by the courts. For example, such contracts may not be enforceable if any of the parties was subject to undue influence, there was no independent legal advice, or full disclosure of financial position was not made. Owner-managers often insist their children enter into such agreements before marriage. In such cases the agreement should be settled well in advance of the wedding date, or left until after the marriage in order to minimize the risk that the agreement will be attacked on the grounds of undue influence.

If creditor protection is important, the protection that insurance products offer will be an important element of the owner-manager's estate plan. If the business owner arranges to have assets held in the name of a spouse for creditor protection, the Will should provide that the property passes into a spousal trust rather than outright to the surviving owner-manager spouse – otherwise creditors of the owner-manager will have access to the inheritance on the death of the spouse.

Creditor protection is in itself a complex area of law. The extent to which property may be shielded from claims of creditors is restricted by many statutes and the common law, and no attempt is made in this course (including in this Study Unit and Study Unit Two) to explore this area of law in any detail. Advisors should be aware that aggressive planning to avoid creditors, particularly existing creditors, may be subject to civil and/or criminal sanctions and these sanctions may extend to participating advisors.

4.2.5 Incapacity Planning

An owner-manager should ensure that business operations will continue during any illness or incapacity. Generally, it is wise to arrange the affairs of the business so that there is more than one officer or director of the corporation, and that more than one person is authorized to sign contracts, sign banking documents, such as loan agreements and pledges, and sign cheques. Under a power of attorney, the attorney may not have immediate authority since powers of attorney do not permit an attorney to carry out any office of a grantor such as a director or signing officer. An attorney in his or her capacity as shareholder under the power of attorney

may be able to appoint him- or herself, but there may be delay or difficulties convincing third parties of the authority of the attorney in such a case. Having additional directors, officers, and signing officers will also protect the operations of the business in the event the owner-manager dies.

Lenders in particular may be sensitive to the dependence of the business on the ongoing presence of the owner-manager. If the owner-manager becomes ill, is there a risk that the bank will call the business loan plunging the business into bankruptcy? Will customers lose confidence in the business and cancel orders? Disability and key person insurance can assist with the monetary problems associated with disability of the owner-manager. Such insurance can also provide funding for a buy out where there are other partners in the business.

4.2.6 Using a Spousal Rollover and a Spousal Trust

A spouse trust can be used to hold the shares of the family business in order to accomplish the following functions:

- defer the tax on death until the death of the surviving spouse,
- control who inherits the business after the death of the surviving spouse, and/or
- provide an income for the surviving spouse without making the spouse the beneficiary of the business.

If the owner-manager is passing the business on to children or other family members, it may be possible to defer the deemed disposition on death by using the spouse rollover by transferring the shares to the surviving spouse or a spousal trust. Where the spouse is not actively involved in the business, and/or the owner-manager wants to ensure that the business is passed to the persons selected in his or her own Will, and not that of the spouse, a spousal trust can be an effective vehicle to defer tax until the death of the surviving spouse and secure the succession of the business. The use of a spousal trust will also ensure that control of the shares is held by the trustees, and not the surviving spouse, if this is a concern. However, there are a number of problems associated with this plan. If there is to be a spousal rollover, the trust must provide that during the lifetime of the spouse all income is payable to the spouse and no one other than the spouse can be entitled to the capital. However, the flow of income to the spouse will depend on the dividends paid by the corporation owning the business, which

in turn will be determined by the directors of the corporation. In addition, if the shares held by the owner-manager are not “freeze shares” (i.e., fixed value shares), the tax payable on the death of the spouse will be on the value at the time of the death of the spouse. If the corporation has increased in value, the deferral would result in a greater amount of tax liability.

It may be convenient to fund the tax payable on death with life insurance. Joint last to die insurance will reduce the cost of the insurance (assuming both husband and wife are insurable) and match the timing of the insurance proceeds with the tax liability on the death of the surviving spouse, whether the spouse receives the shares directly or they are held in a spousal trust. However, the beneficiary of the insurance will differ; the spousal trust should be the beneficiary if the spouse trust holds the assets on which the tax will arise.

Choosing the executors and trustees of the spousal trust can be challenging. If the children and the spouse are trustees, there may be a conflict of interest assuming the children will ultimately inherit the business. In addition, the surviving spouse may have little or no business acumen or interest in the business, making the spouse an inappropriate trustee. If the children alone are to be trustees, care should be taken to ensure the surviving spouse will be provided with appropriate income from the trust to maintain the same standard of living as before the death of the owner-manager. If there is a second marriage, the choice of executor and trustee may be even more difficult, and it may be wise to include an impartial party as an executor.

4.2.7 Leaving the Business to Family Members

If the owner-manager is leaving the business to family members, many decisions must be made regarding the division of the estate. The value of assets is usually divided between business and non-business assets. Beneficiaries may include those who will receive a share in the family business and those who will not. The owner-manager will have to decide how the value of his or her estate will be divided. The examples below provide illustration.

- Is each child to receive an equal share in the value of all assets including the business? This may not be possible if there is an over-concentration of wealth in the business. Insurance to fund equalization among beneficiaries may be one solution.

- If each child is to receive an equal share, will the children receiving the business assets be short-changed with respect to liquid assets because the bulk of their inheritance is received in the form of shares? Should a discount be applied in valuing the shares of the business since there is an inherent risk associated with owning a business as compared to other assets of the estate such as cash?
- Are some children entitled to a share of the business that is disproportionate to the share that other children are receiving from the estate? One child may be the heir apparent of the business, and the parents may both decide that this particular child deserves to receive a larger share of the estate, usually in the form of a share in the business. The result may be an unequal division of value among children, but one that, due to the child's contribution to the business, is fair.

4.2.8 Providing for the Business in the Will

The terms of the Will of the owner-manager should include broad powers to deal with the business. These include the power to carry on or continue to carry on any business, enter into corporate reorganizations, to sell, to borrow, to pledge assets of the estate, to permit family members to purchase assets of the estate, and where family members are executors or trustees to permit them to purchase assets from the estate. These terms will provide maximum flexibility to the executors and beneficiaries to carry out post-mortem tax planning, and structure the distribution of the business and other assets of the estate. The terms should also permit the sale of the business and retention of assets in their existing form at the date of death. The latter will relieve the executors of the obligation to liquidate the family business or to diversify the investments of the estate.

Where there is no specific succession plan in place, as a temporary measure, the Will might provide for a holding period for the business while management and family have time to arrange for an appropriate post-mortem transfer of the business. For example, the Will could provide that a share of the business be retained for a limited period, such as up to three years. This will relieve the executors of any immediate obligation to distribute the business under the terms of the Will, and may permit time to arrange an arm's length sale, management buyout, or transfer to family members.

If a sale of the business is anticipated after death but there is no specific plan, the owner-manager might identify any likely purchasers and leave instructions regarding possible details of any sale for the executor's assistance. For example, some assets, such as trademarks or patents, may have a high value of which the executors might otherwise be unaware. Or the owner-manager may know that particular divisions or aspects of the business can be sold separately for a good price and the balance of the business retained or sold to another purchaser. The owner-manager may also be aware of likely purchasers for the business such as suppliers, customers, or competitors.

While these suggestions are a poor substitute for a more specific succession plan, they may be better than nothing, especially if the owner-manager has no Will or an out-of-date Will that does not address current needs or circumstances.

Where a definite succession plan is in place, the Will, the shareholders' agreement (including any buy-sell agreement), life insurance policies, and beneficiary designations must all be orchestrated to achieve the appropriate result. Where life insurance is intended to fund a buyout, this should be clearly stipulated so that the life insurance proceeds will be used for the intended purpose and not left to the whims of the executors, corporate beneficiaries, or shareholders or directors of the corporation receiving the proceeds.

The shareholders' agreement should be very specific about the mechanism to be implemented when the corporate-owned life insurance proceeds are received by the corporation, and not left to the discretion of the directors of the corporation, shareholders, or others as disputes could arise. The family of the deceased shareholder might expect (or hope) that a capital dividend will be paid to purchase or redeem the deceased's shares, but the surviving shareholders might have different ideas. The life insurance will be added to the corporation's capital dividend account, but will only come out if a capital dividend is declared by the directors. They may declare an income dividend instead.

4.2.9 Ownership of the Family Business

Throughout the rest of this Study Unit it will be assumed that the business is incorporated.

Often the owner-manager will be the sole shareholder of the business. Typically shares are issued on incorporation for a nominal amount. Sometimes shares are

issued equally with the spouse, or with the spouse owning some portion of the common shares.

Multiple numbers of shares should be issued to ensure maximum flexibility in future regarding the use of the spousal rollover. For example, if one share is issued, on death the executor can only choose to rollover the entire value of the company or none of it. If 100 shares are issued, the executor has a range of choice from 1% to 100%.

The use of a corporation permits ownership by multiple individuals or entities. It also permits the value, control, and growth of the corporation to be severed into separate classes of shares, each with particular attributes designed to meet particular objectives. Thus a corporation permits flexibility with respect to designing shareholders' rights.

Owner-managers often participate in a corporate reorganization to crystalize the capital gains exemption. Often this is part of an estate freeze whereby other family members obtain growth shares in the business (i.e., new common shares are issued), and the owner-manager is issued fixed value preference shares. The capital gains exemption has increased several times over the past few years. If a crystallization was completed in the past using only part of the exemption, it may be possible to carry out another reorganization to utilize the remaining portion.

4.2.10 Estate Freeze

One of the most common strategies for owner-managers is the estate freeze. The estate freeze can achieve many objectives.

- The freeze limits the tax liability on death to the value at the time the freeze takes place.
- The freeze enables the owner-manager to plan for the tax liability on death because the amount of gain has been fixed. Thus an estate freeze is often coupled with the purchase of life insurance so that the assets of the business will not be dissipated on death to pay the taxes and the corporation can be transferred to the next generation intact.
- The freeze provides a mechanism to transfer the future growth to other family members thereby engaging them in the success of the

business – if the business grows in value, their interest in the growth shares also increases in value. This can be a reward for their existing contribution to the business and a motivator for the future.

- The freeze can separate the value of the owner-manager's existing interest into control shares with nominal value (sometimes called "thin-voting shares"), and fixed value preference shares that represent the value of the owner-manager's interest at the time of the freeze. This enables the owner-manager to transfer control of the business separately from the value in his or her Will.

Since it is necessary to value the corporation at the time of the freeze in order to ensure that appropriate values are used, and because a share reorganization is taking place in any event, a number of other objectives might be achieved.

- **A Crystallization and Purification:** Simultaneously with an estate freeze, the capital gains exemption can be utilized to increase or "bump" the cost base of the interest held by existing shareholders. If the shares do not qualify prior to the freeze because the value of non-active business assets is too great, it is also possible to strip out excess cash and other non-business assets in a tax-deferred reorganization called a "purification" prior to the crystallization. Unfortunately, the income tax rules prevent using a crystallization to extract property or cash from the corporation on a tax-free basis to the extent the value is in excess of the paid up capital of the shares.
- **Creating a Family Trust to Hold the Growth Shares:** A family trust can not only defer the decision as to which family members will own the business, it can also delay distribution of ownership to other family members and allow the original owners to retain a degree of control over the growth shares by the trust. It can also permit income splitting of dividends paid by the corporation to family members who are 18 or older.[1] The kiddie tax, or tax on split income, will apply to any dividends paid to family members who have not turned 18 in the year. The family trust will be subject to the 21-year deemed disposition rule.

1 As of the date of writing, the Department of Finance had introduced proposals to amend the legislation pertaining to income sprinkling, although nothing had been passed. Verify the current legislation before providing advice in this area.

An estate freeze will almost inevitably multiply access to the capital gains exemption since the common or growth shares will be held by additional family members. The ability to maximize access to the exemption may be the most flexible where the common shares are held in a family trust and the power to encroach on capital can be used to allocate gains to family members who have not already utilized their exemption. The tax on split income (kiddie tax) applies if capital gains are allocated to a minor beneficiary where the sale of the capital property is to a person who is not at arm's length with the minor.

The family law consequences of an estate freeze and children acquiring growth shares or an interest in a family trust should always be considered. This may not be an easy task where children are mobile and the laws of multiple or unknown jurisdictions may be applicable.

Owner-managers should never lose sight of the loss of control and loss of value in the future growth of the business that results from an estate freeze. While the new common shares will initially be worth nothing, all the growth will attribute to them, unless there is only a partial freeze. Introducing new shareholders into the business brings risk of interference. Even with limited or no voting control and restricted rights, corporate law provides remedies for shareholder oppression.

To some extent these risks can be reduced by issuing a control block of voting shares to the owner-manager that have a nominal value, providing that the new common shares have limited rights, placing the growth shares in a family trust, and entering into a shareholders' agreement that provides a buyout provision and other terms favourable to the owner-manager. However, the owner-manager must understand that he or she will no longer be the sole shareholder, and will no longer benefit from the growth in the value.

In some cases, once the true nature of an estate freeze is understood, the owner-manager will decide it is too soon to complete an estate freeze, or may decide on a partial freeze where a portion of the common shares are issued to the freezer as well as other family members so that the owner-manager continues to share in future growth but to a lesser extent. Flexibility may also be achieved by making the owner-manager a beneficiary of the trust although this must be carefully structured to ensure the attribution rules and a number of other tax problems are avoided.

4.2.11 Buy-Sell Arrangements After Death of a Shareholder

In the *Life Insurance* text insurance-funded buy-sell transactions are discussed in detail. The transactions are grouped by individual shareholder transactions and corporate shareholder transactions, and by cross purchase or redemption. In most cases insurance will be held corporately.

4.2.12 Cross Purchase

Cross purchase refers to the situation where the surviving shareholder, or the holding corporation of a surviving shareholder purchases the interest of the deceased shareholder from the estate. The purchaser and seller can be the individual surviving shareholder and the estate, or either of them can be a corporate shareholder of the business – that is, a “holdco” of the corporation that operates the business – “opco.” The tax consequences of a cross purchase are that the purchaser will have an increased cost base in the shares of opco or holdco and the seller will have a capital gain that may be sheltered by the capital gains exemption in some cases.

A cross purchase can be funded by life insurance received by the purchaser directly if the purchaser is the beneficiary of the policy, or by a dividend paid to the purchaser where the insurance is held corporately. Usually the dividend can be paid to holdco as a tax-free inter-corporate dividend (assuming part IV tax is not applicable) or the capital dividend account can be used to pay a tax-free dividend either to a corporate shareholder or an individual shareholder who will be making the purchase. Where the purchase is made by a holdco, the capital dividend account will still be available in future to pay a tax-free capital dividend to an individual shareholder of holdco, but the individual shareholder will not have the increase in cost base, as this will be a purchase by holdco. Where the purchase is made by an individual, the capital dividend account will likely be used to fund the purchase and shelter the tax consequences of the dividend paid to fund the purchase and will not be available in future, but the individual shareholder will have an increased cost base in the shares.

4.2.13 Share Redemption

Share redemption refers to the situation where the survivor makes no purchase. Rather the interest of the estate in the opco is cancelled by a redemption or

repurchase by the issuing corporation – either the opco or holdco depending on the particular circumstances and the buy-sell agreement.

When shares are redeemed or repurchased by the issuing corporation, a dividend is deemed to be paid by the issuing corporation equal to the amount paid on the redemption less the paid up capital of the shares. Paid up capital is the original issue price of the shares when they were issued by the corporation from treasury, and it is usually a nominal amount where the business is held by a private corporation. The tax treatment of a redemption of shares held by a corporate shareholder is generally a tax-free inter-corporate dividend although the capital dividend could be used on the redemption, or the opco could retain the capital dividend account to fund tax-free capital dividends to the surviving individual shareholder in the future. The tax treatment of a redemption in the hands of the estate as shareholder will be either a taxable dividend, or the capital dividend account could be used to shelter the tax on the dividend created on the redemption.

There is also a deemed disposition on a redemption of shares. In calculating the capital gain or loss, the proceeds of the deemed disposition on a redemption will be the amount paid on the redemption, *less the amount of the deemed dividend.* If the shareholder being redeemed is the estate, and there was no rollover to a spouse or spouse trust on death, the tax cost (ACB) of the shares to the estate will be the fair market value of the shares at the date of death. As a result, a capital loss will be created on a redemption of the shares. This loss can be carried back to the terminal return if realized in the first taxation year of the estate. If a capital dividend is used to shelter the tax on the deemed dividend paid to the estate on the redemption, the stop loss rules discussed in the *Life Insurance* text (see Chapter 6 - The Stop-Loss Grandfathering rules) may reduce the capital gain available to be carried back to the terminal return.

The previous two paragraphs describe the tax consequences to the estate where a redemption takes place. For the surviving shareholder, there is no purchase of shares, so there is no increase in the tax cost of the interest in opco or holdco (as the case may be). However, as a result of the redemption the surviving shareholder will own the entire interest in opco as the interest of the deceased individual shareholder has been extinguished on the redemption. The surviving shareholder may have the ability to use the capital dividend account in the future if it has not been used to create a capital dividend to the estate on the redemption.

4.2.14 Determining the Method of Structuring the Buy Sell

There are many arrangements for a buy-sell of shares and these are discussed in detail in Chapter 6 of the *Life Insurance* text. Nevertheless, they are not exhaustive of the post-mortem arrangements that might be utilized, nor are the post-mortem strategies discussed in Chapter 5 for family owned businesses exhaustive. In Chapter 6, it may be helpful to review the "When to use Method ..." sections for each method as a guide to the application of any particular strategy.

Buy-sell agreements and the insurance that funds them will usually be the product of negotiation between the shareholders of a business and the analysis and recommendations of tax advisors and insurance professionals with the assistance of a number of other professionals. Post-mortem tax planning, especially for private corporations and their shareholders, should never be undertaken without the assistance of tax advisors notwithstanding any tax advice and arrangements put in place during the lifetime of the shareholder. The plan must always be reviewed and modified according to the current circumstances and any changes in tax law that may have occurred.

4.3 COMMENTARY ON ASSIGNED READINGS AND CASE STUDIES

Wealth Planning text at 16.8.1 – Estate Freeze

This is an excellent illustration of an estate freeze using an *inter vivos* family trust to hold the growth shares, income split with adult children, and multiply access to the capital gains exemption on a future sale.

On the exchange of their 50 common shares for 1,000,000 preference shares each, they could crystalize the capital gains exemption by electing on the exchange under section 85 of the *Income Tax Act* to have the transaction take place for tax purposes at $800,100 each. The gain on the shares would be reported in each of their tax returns and the capital gains exemption claimed to shelter the entire gain. On the subsequent sale, it would not be necessary for the shares of the corporation to qualify for the exemption since the exemption would have already been utilized to bump up the cost base of their fixed value preference share.

Life Insurance text at Chapter 3 at 3.4 Using Corporate-Owned Life Insurance to Pay Estate Liabilities – see husband and wife

The use of corporate-owned life insurance on the lives of husband and wife who are 50/50 shareholders to pay the tax liability on death arising on shares of a family business is illustrated here.

Life Insurance text at Chapter 5 at 5.2(a) – see Section 85 Freeze

The details of a section 85 estate freeze by Phil in favour of his daughter Freda are explained here. This provision of the *Income Tax Act* permits property to be transferred on a rollover basis to a corporation where shares are taken back as consideration, and the non-share consideration does not exceed the tax cost (ACB) of the property. An election must be filed. Phil's preferred shares would likely have a right to dividends to satisfy the CRA's requirement relating to an estate freeze, but this right to dividends should be non-cumulative and subject to an annual limit. For example, the dividend rate might be 4% or up to 6% of the retraction amount annually, but if in one year no dividends are paid or dividends less than the maximum amount allowable are paid, there is no catch up in future years for unpaid dividends in prior years. These features of the preferred shares are necessary if a true "freeze" is to be achieved.

Life Insurance text at Chapter 5 at 5.2(b) – see Section 86 Freeze

Bertha does an estate freeze for the benefit of Bert, her son, by freezing the value of her existing shares and permitting Bert to acquire new common shares. All the future growth will accrue to the common shares. A section 86 freeze is similar to a section 85 freeze except that it is an "internal reorganization of capital" whereby shares of a corporation are exchanged for new shares of the same corporation. It can also be done by filing articles of amendment that create the share exchange. No non-share consideration may be received and no election is required. A section 85 election can be made in this type of reorganization that would override the section 86 automatic rollover. This might be done where the shareholder wants to trigger a portion of the gain to crystalize the capital gains exemption – as is discussed in 5.2(c).

Life Insurance text at Chapter 5 at 5.2(d) – see Use of Trusts in an Estate Freeze

The benefits of using a family trust to hold the growth shares are discussed in this case study.

Life Insurance text at Chapter 5 at 5.4 – See Estate Equalization

Here the problem of distribution to a participating child and a non-participating child is discussed. The value of the business exceeds an equal value of the estate for the child who will inherit the business. Insurance can be used in these circumstances very effectively. However, it is also important for the parents to decide what they think is a fair distribution among their children, and this is not necessarily always a distribution of assets of strictly equal value to each child.

Life Insurance text at Chapter 6 at 6.1(c) – see Method 1: Cross Purchase – Personally-Owned Insurance

Here we have 50/50 arm's length shareholders Harry and Hannah. In Method 1, a cross purchase takes place with personally owned insurance where each individual owns insurance on the life of the other. For the reasons discussed, this is rarely used.

Life Insurance text at Chapter 6 at 6.1(d) – see Method 2: Cross Purchase – Corporate-Owned Insurance

Method 2 also deals with a cross purchase, but with corporately held life insurance instead of individual. Consideration should also be given to the problems of transferring a policy out of an operating corporation if this is ever needed. This might be better structured with two holding companies owning the insurance or a common holding company above the operating company to avoid the problems of transferring the policies out of the operating business such as might be appropriate in the event of a sale of the corporation to a third party.

Life Insurance text at Chapter 6 at 6.1(e) – see Method 3: Share Redemption Before the Stop-Loss Rules

Here the buyout is fully funded by corporately owned life insurance and 100% of the capital dividend account created by the insurance is used to declare a capital dividend on the redemption of shares held by the estate. This creates a capital loss in the estate that is fully available to be carried back to the terminal return to eliminate the capital gain on death. It is assumed that the capital gains exemption is not available. This works perfectly if the stop loss rules do not apply.

Life Insurance text at Chapter 6 at 6.1(f) – see Method 4: Share Redemption After the Stop-Loss Rules

After the stop loss rules, the benefit of the capital dividend to shelter the tax on the deemed dividend on a share redemption is offset by a reduction in the loss available to carry back to the terminal return. As is shown in the examples a)

the 50% solution, and b) the 100% solution, using the maximum capital dividend (the 100% solution in b) may result in less overall tax as between the estate and the terminal return. Alternatively, if only the amount of capital dividend is used that will not trigger the stop loss rule (the 50% solution in a), the capital dividend account will be available in future for the remaining shareholders. An examination of the narrative in the text along with Schedule 1 — Tax Consequences on page 124 — is helpful.

Life Insurance text at Chapter 6 at 6.1(g) – see Method 5: Spousal Roll and Redeem
This option works well as the stop loss rules do not apply since the deceased uses the spousal rollover on death and the spouse redeems the shares. The capital dividend account can shelter the tax on the deemed dividend on redemption and the deemed dividend reduces the proceeds of disposition for the spouse so that no capital gain is realized for tax purposes. The put and call options create rights. If the spouse is obligated to sell or the corporation obligated to redeem, the spousal rollover will not apply because the shares will not have vested indefeasibly in the spouse (or spouse trust as the case may be).

Life Insurance text at Chapter 6 at 6.1(h) – see Method 6: The Hybrid Method (Individual Shareholders)
There are advantages to both redemption and cross purchase, especially where the capital gains exemption and the stop loss rules are both relevant. As a result, the buy-sell arrangement may be a combination of purchase and redemption.

4.4 SUMMARY OF KEY ISSUES

Planning for business owners is very challenging. There are often multiple complex issues within the family and relating to the business itself. Tax planning, and effective use of insurance to provide liquidity on death for any number of purposes, along with a good succession plan are usually necessary for a smooth transition of wealth and the continuation of the business after death of the business owner.

Motivation is also a challenge. The owner-manager often cannot visualize a future that does not include his or her continued presence. Over time, illness, death of a colleague or family member, or a desire to retire and enjoy life more may be factors in preparing owner-managers for what is a daunting task – the contemplation of death, taxes, and transfer of control and ownership of the business. Family members, particularly the spouse, existing advisors, and business

partners often play a role in getting the owner-manager to address succession and estate planning. Surprisingly fear – either of overpaying taxes, failing to protect the inheritance from a family law claim (from one's own spouse or that of a child), or some other source – will sometimes bring them rushing to the task.

Where the business is small and family owned the use of the capital gains exemption may be a significant objective. Crystallization, purification, and strategies to multiply access to the exemption will be relevant. Where the business is larger in value and/or there are arm's length partners, the capital gains exemption may be of lesser importance or not much importance at all.

The spousal rollover and use of discretionary family trusts are important strategies for the business owner. The impact of family law on transfers of an interest in the business and on the right of anyone to make a claim against an inheritance must always be considered.

The estate freeze is an important part of estate planning for business owners. When, why, and how to implement an estate freeze must be understood in order to provide guidance to the owner-manager with respect to the transfer of the business to family members. One of the most important elements of the estate freeze is working with the owner-manager to ensure he or she appreciates the consequences of the freeze, and is fully prepared, in the business cycle, at the stage of life, and in relation to family dynamics, to carry it through.

Planning for the tax consequences of death and the transfer of the business before or after death is another challenge for the owner-manager and his or her advisors. Insurance can provide funds to equalize estate distribution among beneficiaries, provide liquidity to individual beneficiaries, fund the taxes on death, and fund a buyout by an arm's length partner or family member. Shareholders agreements and buy-sell agreements (usually in the same agreement) can anticipate the death of an owner and provide for the transfer to surviving shareholders. The tax consequences of death of an owner of a business, and the tax treatment of the transfer of the business after death are complex. Many post-mortem tax planning strategies exist for estates owning shares of a private corporation, and only some of them have been discussed in the materials, and, even then, the discussion has not been complete as to detail.

A team of professional advisors can usually best serve a business owner as their requirements almost always cut across many disciplines. No one advisor can

master all the expertise required. Recognizing the areas of expertise required, bringing in the appropriate professionals, and working together for the benefit of the client is especially important for the business owner whose needs are so complex.

4.5 TERMINOLOGY

Crystallization: A transaction whereby the capital gains exemption on qualifying property is realized for tax purposes only by incorporating the amount of the exemption into the cost base of the qualifying property. The owner of the property does not change, and generally proceeds are not received by the individual owner (although in limited circumstances non-share consideration may be received but the amount that can be received is restricted by the *Income Tax Act*). The purpose is to boost the tax cost of the property by the exemption in the event the property does not qualify for the exemption in the future.

Estate Freeze: A transaction whereby property of an individual is fixed in value but the value of the future growth is transferred on a tax-free basis to the persons who will inherit the property.

Purification: A transaction whereby the assets in a corporation are altered so that 90% of the value of the assets in the corporation (or in the corporate group where there is more than one corporation) is used in an active business carried on primarily in Canada. Usually this is accomplished by a corporate reorganization whereby non-qualifying assets are stripped out on a tax-deferred basis to a corporation held separately by the individual shareholders.

REVIEW QUESTIONS AND ANSWERS

Questions

1. What is the benefit of crystallization? Are there any potential disadvantages?

2. In what circumstances other than an estate freeze, should crystallization be strongly considered?

3. Why must fixed-value preference shares be received by the shareholder on an estate freeze? Why must the shares and other consideration received by the shareholder in exchange for the existing shares (in the course of an estate freeze) be equal in value to the existing value of his or her share ownership in the corporation at the time of the freeze? What happens if the value of the corporation used for the purposes of the estate freeze is subsequently challenged by CRA?

4. Capital loss on redemption of shares:

   (a) Explain how a loss is created when the estate redeems shares held by the deceased.

   (b) What is the advantage to redeeming shares in the first year of the estate?

   (c) What is the paid up capital of shares, and how does it differ from the adjusted cost base?

5. List four (4) advantages of corporately owned life insurance.

Answers

1. The benefit of a crystallization is that it utilizes the capital gains exemption to increase the cost base of qualifying property. For shares of a qualifying small business corporation, this has the advantage of "locking in" the exemption at a time when shares qualify. If in future, the shares no longer qualify, the shareholder has still sheltered future gains with the higher cost base. Without the crystallization a future sale might not qualify for the exemption. There are some potential disadvantages. One obvious one is where the individual has more than one property or properties that qualify

for the exemption. For example, a shareholder may own more than one corporation that qualifies, or may also own qualified farm property. If the exemption is fully utilized on one property and another qualifying property is sold first, the exemption will not be available for that sale.

2. If a business is being sold by way of an asset sale, or a private company is converting to a publicly traded company, a crystallization should be carried out as the shares of the corporation will not qualify in the future.

3. The shares must have a fixed value so that the growth in the value of the corporation will accrue to the new common shares issued to other family members. The consideration received by the "freezor" must equal the value of the shares exchanged. If they are worth less, then a benefit will have been conferred on the common shareholders that will be taxable to the freezor or the common shareholders. If worth more, the new common shares will not have any value until the increase in value of the corporation matches the value of the preference shares and this is not consistent with the purpose of the freeze. If CRA challenges the value, a price adjustment clause may be used to adjust the value of the preference shares. The price adjustment clause must have been incorporated into the terms of the estate freeze, and the original value used must have been reasonably ascertained.

4. Capital loss on redemption of shares:

   (a) Redemption of shares gives rise to both a deemed dividend and a disposition of shares in the hands of the shareholder, in this case the estate. The dividend is the amount of the consideration received on the redemption less the paid up capital of the shares redeemed. The proceeds of disposition on the disposition of the shares is reduced by the deemed dividend. Because the estate has a high adjusted cost base (the fair market value at the time of death resulting from the deemed disposition at death), the reduction of the proceeds of disposition on the redemption creates a capital loss that can be carried back to the terminal return of the deceased in the first year of the estate.

   (b) If the redemption takes place during the first tax year of the estate, any loss can be carried back to the terminal return. This may be particularly advantageous if there is a capital dividend account

available to shelter the tax on any deemed dividends received by the estate on the redemption.

(c) Paid up capital is generally the same as corporate capital on the balance sheet (i.e., the original subscription price of the shares when they were issued from treasury by the corporation). There may be some adjustments to paid up capital for tax purposes. Adjusted cost base is the tax cost of the shares. Adjusted cost base might be the same as paid up capital for the original subscriber for the shares but for any subsequent purchaser it would be the purchase price from the former shareholder, subject to tax adjustments.

5. See page 110 of the *Life Insurance* text.

(a) Premiums are payable in cheaper after-tax dollars especially if the corporation qualifies for the small business deduction.

(b) It permits flexible buy out strategies – that is, either purchase or redemption, depending on which is preferred in the circumstances, whereas individually held insurance permits only purchase.

(c) Cash may be available in the corporation and would be subject to tax on payment out to the individual if used personally to fund insurance premiums – either as dividend or salary/bonus.

(d) Owner-managers may be more comfortable using corporate rather than personal dollars to purchase life insurance.

6. There may be a taxable event to the corporate owner of the policy if the policy needs to be removed from the company on a sale to a third party; if the operating company is sold, the insurance policy cannot be transferred out of the company on a tax-free basis since there is a disposition of the policy for proceeds equal to the cash surrender value (CSV) with resulting potential adverse income tax consequences. In addition, any transfer of the policy to an employee or shareholder for less than fair market value can result in a taxable benefit to the shareholder or employee.

STUDY UNIT FIVE

ESTATE PLANNING WITH LIFE INSURANCE

Knowledge Objectives

Skills Objectives

Topics Covered

Related Textbook Readings

5.1 INTRODUCTION 5-3

5.2 ESTATE PLANNING WITH LIFE INSURANCE 5-3

5.2.1 The Need for Liquidity on Death 5-3

5.2.2 Factors in Identifying the Need for Life Insurance 5-5

5.2.3 Beneficiary of Life Insurance 5-6

5.2.4 Corporately-Owned Life Insurance 5-7

5.2.5 Life Insurance Planning 5-8

5.2.6 Buy-Sell Agreements 5-9

5.3 TERMINOLOGY 5-10

REVIEW QUESTIONS AND ANSWERS 5-13

APPENDIX 5.1 Excerpt from the Advocis LLQP 2017 TFAAC material, Life Insurance Products 5-19

Study Unit Five

Estate Planning with Life Insurance

Learning Objectives

Knowledge Objectives

Upon completion of this unit the student will understand the different types of life insurance and how they can be used to achieve estate planning objectives.

Skills Objectives

Upon completion of this unit the student will be able to assess the need for life insurance to support the estate plan and (in conjunction with the insurance content of other Study Units) recommend alternative insurance strategies.

Topics Covered

- Use of Insurance in Estate Planning
- Types of Insurance and Their Uses

Related Textbook Readings

Estate Planning with Life Insurance
Glenn R. Stephens, LL.B.

Chapter 3 Life Insurance and the Need for Estate Liquidity
Chapter 4 Introduction to Corporate-Owned Life Insurance

Wealth Planning Strategies for Canadians
Christine Van Cauwenberghe, B.Comm. (Hons), LL.B., CFP , TEP

Chapter 25 Insurance

5.1 INTRODUCTION

No study of estate planning is complete without the inclusion of life insurance. Understanding the importance and uses of life insurance are integral to the skill set all professionals in estate planning must have. The insurance advisor plays a key role in the uses of insurance and the estate plan, however other professionals must also be familiar with the basics. The insurance advisor may need to rely on other professionals for the details relating to insurance, including trust and tax law, and selecting the appropriate policy holder, and designated beneficiary.

Many estate plans fail to properly co-ordinate the insurance planning with the other aspects of the plan and unfortunately often serious deficiencies are not discovered until the insured has passed away. The lawyer, accountant, and other professionals who work together with the insurance advisor in a team environment will be doing the client and his or her beneficiaries a great service as well as reducing the exposure to potential claims.

The primary role of insurance is funding. Life insurance obviously provides funds on death and this can be utilized for many purposes essential to the effective estate plan.

5.2 ESTATE PLANNING WITH LIFE INSURANCE

5.2.1 The Need for Liquidity on Death

Often tax planning is seen as the primary goal of estate planning, although this is quite a myopic view of estate planning as it encompasses many other objectives. Tax savings may often be used to motivate a client to initiate estate planning, and advisors often encourage this view to bring the client to the task. Once the planning has commenced, however, many other objectives become apparent.

Life insurance is primarily used to fund liabilities and other obligations on death but is by no means the sole use of life insurance. For example, it can also be used to provide additional funds to make distribution to family members fair, or fund charitable gifts. The two objectives of reducing liabilities and funding gifts can be effectively carried out through collaboration among professionals from different fields to ensure that both the client's tax savings are optimized and that the appropriate amount of funding is obtained to achieve the plan objectives. The need for liquidity on death is usually apparent, but specific quantification of

the need can make the need for life insurance more compelling. Assuming there are no business assets, a list of the liabilities on death may include the following:

- funeral expenses,
- taxes owing by the deceased in respect of the current and/or previous years,
- taxes owing as a result of death, such as capital gains and taxation of registered plans,
- probate fees,
- executor compensation,
- cost of liquidating assets as part of administration of the estate including appraisals and real estate commission,
- support of spouse and minor children,
- support of adult children's continued post-secondary education, and
- obligations triggered by death under contracts (such as separation agreements), bank loans or guarantees.

It is often an eye opening exercise for clients to have an inventory done of all the assets of the estate and funds available on death, along with a calculation of the liabilities arising on death. Ideally these calculations should be done as future projections. However, sophisticated software and many difficult assumptions are required, including date of death of the client and his or her spouse, who dies first, future asset value, and status of obligations on death. An analysis can be done on a present basis, as if the client died immediately. This can bring the actual financial consequences of death into focus, and alert the client and the advisor to planning and funding issues.

Business owners have additional requirements for insurance that emanate from a number of factors requiring additional funding on death.

- Taxation of the business owner/shareholder on death
- Desire to pass business to family members creating liquidity problem
- Disproportionate amount of wealth tied up in the business

- Need for equalization to be fair to beneficiaries who do not inherit the business
- Desire to provide all beneficiaries with cash as well as business assets
- Need to fund buy/sell provisions in shareholders' agreements
- Professional fees to design and implement post-mortem planning
- Cash requirements to sustain the business after death of a key employee/owner/manager
- Retire business loans as a term of financing

Liquidity problems for business owners can be acute whether the business is to stay in the family or not. If there are other partners or shareholders in the business, there may be contracts in place to provide for obligatory purchase or redemption on death. If the business is to be sold following death, funds will be required to sustain the business while a purchaser is sought, and to finance the estate expenses during the pre-sale period as privately held businesses are not readily converted into cash.

5.2.2 Factors in Identifying the Need for Life Insurance

Situations requiring insurance typically result from one or more of the following factors:

- property is to be transferred in kind to beneficiaries,
- assets are not readily converted into cash – such as real estate or business interests,
- there is an imbalance in distribution among beneficiaries that requires funding to adjust,
- dependants or other beneficiaries require ongoing support,
- there is significant charitable intent with insufficient funds,
- income tax and other liabilities exceed the cash available on death,
- bank loans or other financing will become due on death,
- there is a desire to secure an inheritance for one or more beneficiaries,

- insurance is required by contract (such as a separation or shareholders' agreement),
- funding is required for a buy out of a business interest, or
- other needs arising from business interests.

A thorough review of the specific individual's situation and objectives can assist in uncovering insurance needs and opportunities, which may not otherwise be obvious at the outset.

5.2.3 Beneficiary of Life Insurance

It is important to consider the beneficiary of life insurance carefully. In choosing the beneficiary for life insurance attention must be paid to the purpose of the insurance and many other factors, including creditor protection and probate fees.

For example, often a policy taken out to pay taxes on death or provide liquidity names the children or other beneficiaries of the estate as the beneficiaries of the life insurance. This can be inappropriate since the legal obligations to be funded are those of the estate, whereas an individual beneficiary of the estate is receiving the insurance proceeds. This is not the right legal result and the insurance beneficiary may be under no obligation with respect to the use of insurance proceeds.

On the other hand, making the estate the beneficiary of insurance can expose the proceeds to creditors of the estate, and subject them to probate fees. Naming a beneficiary by way of an insurance declaration in the Will and appointing a trustee (who may also be the executor of the Will) for insurance is sometimes done with the intent that the proceeds will fall outside the estate to avoid this result. However, based on the *Carlisle* decision in Saskatchewan, this also must be done carefully.

Note that while a testamentary insurance trust can be created using a designation that is provided in an individual's Will, the designation/declaration must be done in accordance with the *Insurance Act*. Where the estate is the intended beneficiary of the funds, however, such as where the money is to be used to pay estate liabilities, the inclusion of insurance proceeds in the estate cannot be avoided exposing the insurance proceeds to probate fees (where applicable) and potential liability to creditors.

5.2.4 Corporately-Owned Life Insurance

If insurance is corporately owned, generally the corporation or a related corporation, and not an individual, should be the beneficiary. Otherwise the individual may be subject to a taxable benefit on the premiums, and if the insurance was taken out corporately, it is likely that the original planning intended that the proceeds be added to the corporate beneficiary's capital dividend account (CDA). If this was not intended, perhaps the corporation should not be the owner of the policy.

A simple example of corporately-owned life insurance to fund the tax liability on shares of a private business is illustrated on page 88 of the *Life Insurance* text. The best place to house instructions regarding the payment of corporate-owned life insurance proceeds and CDA is in a shareholders' agreement. This would bind the corporation to carry out the planned use of insurance proceeds. One problem is that in sole shareholder situations where it is not common for there to be a shareholders' agreement. In practice, Wills seldom contain such provisions, although it would certainly be prudent to include them where the insurance proceeds are intended to be used for a specific purpose by the corporation. It should be pointed out, however, that a direction in the Will would not be binding on the directors of the corporation, and may not be capable of being implemented depending on the circumstances.

Executors have an obligation to do what is in the best interests of the estate and the beneficiaries. As shareholders of a corporation owned by the deceased, they may be in a position to elect the board of directors of the corporation and it may be possible to effect the directions in that manner. However, the directors of a corporation (even if they are the same persons as the executors) have an obligation to do what is in the best interests of the corporation. These obligations may or may not be consistent with the direction given by the shareholder.

In addition to the benefits of corporately-owned life insurance as outlined in the *Life Insurance* text, life insurance can be used to fund tax-effective corporate distributions. Because the CDA can be paid tax free to an individual shareholder (either directly or through a corporate chain of capital dividends) the purchase of life insurance can be a tax-efficient way of effecting distribution of corporate funds – the cost of premiums (the funds which would otherwise be paid out of the corporation by way of taxable dividends) is converted into life insurance

proceeds, which have been invested in a tax deferred policy, that after death can be paid out tax free from the corporation in the form of capital dividends.

Despite the considerable tax benefits of corporately held life insurance, it is rarely sold or marketed as a “tax shelter” *per se*. From a policy perspective (fiscal policy), the generous rules in the *Income Tax Act* for life insurance are based on the presumption that it is a product that primarily is used to deal with mortality and that is not purchased solely because of the tax advantages.

The perils of holding corporately-owned life insurance in an operating company are well described in the *Life Insurance* text in Chapter 4. The difficulty of extracting a life insurance policy from a corporation on a tax-effective basis contrasts sharply with the ease of transferring a life insurance policy to a corporation. Note that in the latter case tax liability will still arise if the cash value of the policy exceeds its adjusted cost base. In some situations, split dollar and split beneficiary insurance can be used to get the benefits of insurance that serves multiple needs without some of the problems associated with having the policy held solely by the operating corporation.

5.2.5 Life Insurance Planning

Just as it is important to think through all the “what ifs” when drafting a Will and designing an estate plan in general, it is imperative that when purchasing life insurance professionals carefully consider all the implications of:

- the owner of the policy (individual or corporate and which corporation),
- the life insured (joint or single lives, for example),
- the type of insurance (term or permanent),
- face amount,
- beneficiary (or beneficiaries), and
- purpose of the insurance – short term and long term.

The benefit of teamwork among professionals, including the lawyer, accountant, and insurance professional, to make sure all relevant issues are considered and that the structure of the insurance is properly implemented cannot be overemphasized. The Case Studies in Chapter 7 of the *Life Insurance* text, dealing

with shareholders' agreements, illustrate some of the serious problems that can result when professionals do not work together. The legal documents (including the Will, beneficiary designation, shareholders' agreement and buy-sell provisions) should work together and be consistent with each other.

5.2.6 Buy-Sell Agreements

Life Insurance text at Chapter 7 at 7.1 – see Case Study Number 1

This case study shows how insurance and the terms of shareholders' agreements can become problematic over the passage of time as circumstances change. Setting a price equal to the amount of life insurance is usually inappropriate as the value will change, but the insurance may not and this can thwart the intentions of the parties regarding the purchase price, and result in adverse tax consequences. The possibility of U.S. citizenship should always be investigated because of the potential for U.S. estate tax and the significant negative impact if a U.S. citizen is the beneficiary of insurance, or the policy owner. The amount of insurance should be reviewed on a regular basis if it is to fund a buyout to ensure the obligation is funded accordingly.

Life Insurance text at Chapter 7 at 7.1 – see Case Study Number 2

This case study illustrates the need for an appropriate methodology (and terminology) for determining the price under a buy-sell agreement. It also illustrates the need for teamwork among professionals. Seldom is book value an appropriate price for an ongoing business.

Life Insurance text at Chapter 7 at 7.1 – see Case Study Number 3

This case study shows how legal documents can have inconsistencies if not carefully drafted and reviewed, and the need to consider the interests of the majority and minority shareholders. An inconsistency with respect to the buy-sell obligation could cause serious problems when the obligation is triggered, including litigation and liability for the professionals involved.

Life Insurance text at Chapter 7 at 7.1 – see Case Study Number 4

This case study highlights the need to make sure that life insurance paid to a particular beneficiary to purchase the shares of a deceased shareholder has been formally committed to that purpose.

A number of factors are material to the use of insurance and buy-sell agreements. A checklist of such factors includes the following:

- ownership of the policy,
- life insured,
- beneficiary,
- amount of insurance,
- type of insurance,
- events that trigger the buy-sell,
- whether buy/sell provisions are optional or mandatory,
- method for determining price,
- identity of the purchaser and the seller,
- obligation to use the insurance to fund the buy-sell,
- excess insurance provisions
- flexibility with respect to sale or redemption,
- availability of the capital gains exemption,
- obligation to use the CDA to fund the buy-sell, and
- method for keeping the arrangement updated.

Many shareholders' agreements and buy-sell arrangements fail to adequately address these issues.

5.3 TERMINOLOGY

Cash Surrender Value (CSV): The amount, if any, available in cash upon surrender of a life insurance policy during lifetime of the insured, after all charges are incurred (i.e., some policies may impose surrender charges for early cancellation of a policy). Many policies, such as term insurance policies, do not have CSV.

Cash Value: This term is sometimes used interchangeably with CSV. However, it is also used to refer to the amount of the death benefit that exceeds the face amount; amounts attributable to dividends paid (and that during lifetime of the life insured

are reflected in the CSV); or the value within the policy before surrender charges are applied.

Death Benefit: The amount payable from a life insurance policy to a named beneficiary as the result of the death of the life insured. For many permanent life insurance policies this includes the face amount and any additional amount attributable to the cash value of the policy.

Face Amount: The amount insured under a life insurance policy. It generally represents the amount of risk assumed by the life insurance company. It does not include other amounts such as policy dividends or cash value payable in excess of the face amount on the death of the life insured party. The face amount may also be referred to as the "sum insured."

Guaranteed Cash Surrender Value: That portion of the cash surrender value of a life insurance contract that is guaranteed and is usually set out in the terms of the contract. The guaranteed cash surrender value does not include such variables as reinvested dividends. Only certain types of policies have guaranteed cash surrender values.

Life Insured: The person whose life is insured under the life insurance policy. There could be more than one life insured, such as with a joint last-to-die policy or multi-life policy.

Net Cost of Pure Insurance (NCPI): This refers to the mortality cost as determined under the Income Tax Regulations. The NCPI is relevant for determining a policy's adjusted cost base, and for calculating the deductible amount of premiums where a policy is assigned as collateral for loans.

Permanent Insurance: Insurance that continues for the life of the insured. Whole life and universal life are the two most common examples. These policies have a face amount and may also have an additional value that accumulates based on certain reserve calculations and investments of the premiums not required to fund the current cost of insuring the face amount. Over time the value of the CSV or cash value on death can exceed the face amount, although this is not typical.

Policy Owner: The person who has legal ownership of the policy and who has the right to designate a beneficiary. Change of ownership is a disposition for tax purposes and any gain or loss is not a capital gain or loss, but an income account.

Term Insurance: A life insurance policy that covers a specific period, such as one or more years, after which the insurance expires. It pays a death benefit equal to the face amount if the life insured dies during the term, although there may be additional benefits or riders, such as conversion rights, and options for additional terms. It has no CSV and is the cheapest form of life insurance over the short term. Over the longer term, however, term insurance can become extremely expensive. For this reason it is recommended for short-term insurance needs, but not for the permanent needs that frequently arise in an estate planning context.

Universal Life Insurance Policy: A life insurance policy in which premiums (less expense charges) are credited to a policy account from which periodic charges for life insurance coverage are deducted and to which interest or investment earnings are credited. Policy owners are able to choose from a variety of investment accounts. Usually the policy owner can vary the amount and timing of premium payments and change the amount of insurance (subject to underwriting).

Whole Life Insurance Policy: Premiums are payable for the entire life of the policy. The policy ceases or matures when the death benefit is paid on the death of the life insured or in very rare cases when the life insured reaches age 100. At that point, the policy reserve will have accumulated to equal the sum insured.

REVIEW QUESTIONS AND ANSWERS

Questions

1. List four (4) reasons corporately held life insurance might be held by a holding corporation (Holdco) rather than a subsidiary that operates the on-going business (Opco) and provide a brief explanation for each.

2. List six (6) advantages of corporately held life insurance and provide a brief explanation for each.

3. What is the difference between split dollar life insurance, and split beneficiary life insurance?

4. For each of the following, would term or permanent insurance be recommended? Briefly explain, and if applicable are there any other particular recommendations you would make regarding the insurance?

   (a) A husband and wife wish to provide a fund to support a mentally handicapped child.

   (b) A shareholder wants to pay the income tax liability arising on death in respect of freeze shares in the business.

   (c) A single mother wishes to ensure her children receive post-secondary education.

   (d) A corporation wants to ensure additional funds are available if a key employee dies, and also wishes to provide an incentive to the employee to stay with the company.

   (e) Under a separation agreement, a father has an obligation to purchase insurance in the amount of $500,000 in lieu of support payments in the event of death payable to the wife until the oldest child is age 25.

   (f) A business owner who expects to sell his business to his younger partners/co-shareholders in ten years and retire on the proceeds wants to ensure that his wife has sufficient funds to maintain her lifestyle.

(g) A business owner has sold the business and wishes to set aside one part of the proceeds to fund his or her own needs and that of the spouse during the remainder of their lifetimes and secure the remaining portion of the proceeds to distribute to other family members or beneficiaries on death.

5. Why should a shareholders' agreement be reviewed in conjunction with insurance planning for a business owner? List your reasons.

Answers

1. Reasons for corporately-owned life insurance to be in a holding corporation:

(a) Creditor protection – assets in Opco will be subject to persons who have claims against the business, including creditors and litigants. The insurance proceeds can usually be sheltered from such claims in Holdco (assuming Holdco has not guaranteed the debts of Opco).

(b) Holdco may have more funds available than Opco – if a Holdco is in place, tax-free dividends are often paid up to Holdco as part of a creditor protection strategy. These sheltered funds can be used to purchase the life insurance.

(c) Where there are individual shareholders, as well as a corporate shareholder, to preserve Opco's eligibility for the capital gains exemption for the benefit of the individual shareholders – i.e., to help ensure the shares continue to be shares of a qualified small business corporation. The CSV of life insurance is a non-business asset that may disqualify Opco from the 50% test or the 90% test. Holding the policy in Holdco will help preserve the right of any individual shareholder of Opco to the capital gains exemption.

(d) To permit tax-free retention of the policy if Opco is sold to a third party. If the policy is held in Opco, a subsequent transfer of the policy may attract severe income tax consequences.

2. Advantages of corporately held life insurance:

(a) The funds may be available in the corporation if not available personally.

(b) In most cases, the cost is more tax efficient than paying from personal funds because corporations typically pay tax at a lower rate than individuals, and therefore need to earn less income in order to have the same after-tax dollars with which to pay premiums.

(c) The client may find it more attractive from a psychological standpoint to have the corporation pay rather than pay the premiums personally.

(d) The CDA provides for tax-efficient distribution of the proceeds of the policy from a corporation to an individual shareholder.

(e) Corporately held insurance is more flexible for post-mortem planning permitting either redemption of shares held by the deceased, or purchase of the shares by another shareholder, depending on the desired tax treatment, including the availability of the section 164(6) loss carryback in the case of a redemption, or the use of the capital gains exemption in the case of a purchase.

(f) Corporately held insurance may be seen as more secure and better suited to fund buy-sell obligations between arm's length parties especially where there are policies on the lives of multiple owners, and differences in premium costs can be better managed.

3. In split dollar life insurance the cash value and face amount of the policies are owned by different persons and each can name a beneficiary of their respective interests; whereas in split beneficiary insurance, there is only one policy owner who names two or more separate beneficiaries under the policy.

4. Identify term or permanent insurance, with brief explanation, along with brief recommendations, if any:

   (a) Permanent – the child's needs will continue during and after the parents' lifetime. The parents may want to secure the child's future financial needs with a policy that is creditor protected. A joint last-to-die policy may be appropriate as premiums may be reduced on the assumption that the parents will fund the child's needs during both their lifetimes. If the estate plan includes the use of a Henson trust or qualified disability trust in the parents' Will, then the disabled child should not be designated as the direct beneficiary of the insurance policy.

(b) Permanent – assuming the shares will be held until death and not redeemed – the tax liability is crystalized on a freeze so life insurance provides the perfect funding – the timing matches the liability, and the amount required can be quantified when the policy is purchased. If there is a spouse who will inherit the freeze shares first, joint last-to-die might be considered.

(c) Term – the insurance need will end when the child completes post-secondary education. If he or she has no other insurance needs, term should be sufficient, and the most cost effective for this need.

(d) Permanent insurance – to meet the needs of the key employee – although term may be all that is needed by the corporation – this may be a good situation for split dollar or split beneficiary insurance.

(e) Term – the obligation ceases after the youngest child attains age 25.

(f) Permanent – universal life insurance may provide the most flexibility here (to fund a buy-sell if he dies before a sale to his partners is completed, and to provide a tax-effective way of distributing funds from his business) assuming he will have a Holdco and that some of the proceeds will be held corporately; and to enable him to make additional deposits to the policy once he has the proceeds of the sale to fund growth of the cash value.

(g) Permanent insurance – the investment and creditor protection aspects of universal life insurance will provide the security he or she desires and maximize the amount of the inheritance.

5. Reasons to review the shareholders' agreement in considering insurance planning for business owner:

(a) To understand and review the obligations and/or needs that require funding, including:

i. What is the provision for disability?

ii. What are obligations on death of a shareholder?

(b) To ensure there is a reasonable method to determine the price at which any buy-sell will take place.

(c) To determine, in conjunction with the client's other advisors, whether there is a tax-efficient buy-sell structure in place.

(d) To ensure the agreement is consistent with the insurance plan.

(e) To obtain information about the corporate structure and business owners – i.e., to help consider who should be the life insured(s), which corporations are candidates for the policy owners, and how the premiums should be funded.

(f) To confirm that a legally binding shareholders' agreement has actually been put in place (not just an unsigned draft).

APPENDIX 5.1

Excerpt from the Advocis LLQP 2017 TFAAC material, Life Insurance Products

SUPPLEMENTARY MATERIALS

LIFE INSURANCE PRODUCTS

5:1 LIFE INSURANCE IN ESTATE AND FINANCIAL PLANNING

5:2 BASIC LIFE AND HEALTH INSURANCE PRODUCTS

5:3 POLICY PROVISIONS

5:4 TERM INSURANCE

5:5 PERMANENT LIFE INSURANCE

5:6 UNIVERSAL LIFE INSURANCE AND INVESTMENT OPTIONS

5:7 BUSINESS APPLICATIONS FOR LIFE INSURANCE

5:8 POLICY BENEFITS AND RIDERS

5:9 RECOMMEND THE “BEST” PERMANENT LIFE INSURANCE PRODUCT

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5:1 LIFE INSURANCE IN ESTATE AND FINANCIAL PLANNING

There are three basic sources of life insurance protection for most Canadians:

1. Government plans

The Canada Pension Plan and the Quebec Pension Plan each offer a limited death benefit to plan contributors, to a maximum of $2,500.

2. Group plans

Employer-employee group insurance plans normally contain a mandatory life insurance component for the plan member and optional insurance amounts for the plan member and his or her spouse or common-law partner and dependent children.

Benefits on the life of the plan member are usually a function of the employee's salary and are generally capped at about four or five times salary. For example, an employee earning $50,000 a year might be given a basic group life insurance benefit of $50,000, which could be expanded to as much as $250,000. Benefits on the lives of dependants are usually fixed and modest, $5,000 to $25,000 at most. Coverage is often lost should the plan member leave the employer.

Association group plans offer far more flexible levels of coverage on the life of the group member and, often, limited coverage for his or her family members.

3. Individual plans

Individual life insurance plans are owned by the insured and are fully portable (they can be moved from jurisdiction to jurisdiction, are not dependent on employment with or membership in some organization and can even be transferred from person to person). The amount of coverage that a person can have under an individual life insurance plan is limited only by the person's ability to demonstrate that the coverage applied for is reasonable and supportable in the circumstances, and by his or her ability to pay for the coverage.

ADVANTAGES OF INDIVIDUAL PLANS

Individual life insurance policies afford the client the options required to make them an integral part of every financial and estate plan. They are:

- **Flexible:** The type and amount of coverage applied for can (within limits) be tailored to meet the needs of the applicant and his or her ability to pay. There are no fixed limits or maximums on the amount of coverage, the way there are with government and group plans.
- **Adaptable:** The amount and type of coverage can often be changed (increased, decreased, the plan type amended, etc.) after the plan has been issued to suit the insured's changing needs.
- **Portable:** The coverage can be taken with the insured from province to province or even to other countries. Once issued, individual life insurance policies can even be transferred to other individuals or organizations without affecting the insurance coverage provided.
- **A tangible asset:** The death benefit payable under any individual life insurance policy can be assigned to a third party as collateral. The values of a cash value life insurance policy can be withdrawn, borrowed against or assigned.

Personal financial needs

Life insurance (like all types of insurance) is fundamentally based on the concept of indemnification: The policy death benefit is intended to compensate (indemnify) the beneficiary for a loss suffered as a consequence of the death of the life insured.

The loss may be:

- **Immediate and finite:** Funeral costs.

Example: When Dan died last month, his funeral cost $9,000. Dan's life insurance agent had factored funeral costs into Dan's insurance plan, so that the insurance proceeds payable at Dan's death included an allocation of $10,000 to pay all funeral expenses. This provision relieved Dan's estate (and his heirs) of the direct financial responsibility for his funeral.

- **Ongoing:** Family financial needs.

Example: Dan left a widow and two preschool children surviving at his death. The family relied primarily on Dan's earned income, so Dan's insurance program had been designed to provide a specific sum

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of capital in the event of his premature death. These funds are earmarked to be invested to generate the amount of income that the family would need to live on, at least until the children could be expected to be in school full time, when Dan's widow would probably resume her own career.

- **Indirect:** The effects of grief.

Example: Abdul and Saba have been married for only two years and are deeply devoted to each other. Both have their own independent careers, but Abdul is concerned that, if something were to happen to either of them to cause a premature death, the survivor might be so devastated that he or she would not be able to work for a lengthy period of time and would need emotional support. To deal with this concern, Abdul's life insurance agent built an element into each of the couple's insurance programs that would provide sufficient capital (death benefit) to permit the survivor to take a six-month sabbatical from work and to take a prolonged trip to their homeland to garner emotional support from their families.

These represent a form of loss (either a loss of pre-existing income or an expenditure triggered as a result of death) for which insurance proceeds can protect the life insured's estate or dependants.

More specifically, the personal needs covered by life insurance tend to fall into four general categories:

1. FINAL EXPENSES

When a person dies, his or her last expenses become the family's first expenses. There are some final expenses that could be expected regardless of whether or not the person was earning an income. These are typically triggered as a direct consequence of death:

- Final medical bills (doctors, ambulance, hospital and nursing fees).
- Funeral and burial costs.
- Probate costs, lawyer's and executor's fees.

Other expenses (which may not be triggered by the death but should be paid in full at death) are often more closely associated with the death of an income-earner:

- Current bills for household and personal expenses.
- Bank debts or other outstanding loans, mortgages or credit accounts.
- Instalment purchase debts or leases (for example, automobile, personal computer).
- Unpaid property taxes.
- Unpaid income taxes, including tax on any capital gains and the proceeds of registered retirement savings plans (RRSPs) triggered as a consequence of death.

Life insurance allows survivors and/or heirs to be relieved of the debt (and the carrying costs associated with that debt) left by the deceased. At a time when surviving family members are dealing with loss, it's a great comfort to know, for example, that they can afford to continue to live in the family home, debt-free, and maintain as much of their normal lifestyle as is possible.

2. AN EMERGENCY FUND

Most financial advisors recommend that families have a liquid emergency fund equal to at least three months' total family income to deal with a possible serious illness, accident or unexpected expensive home repair that could devastate the family budget. The fund could be maintained in the form of a savings account, a Canada Savings Bond or some other safe, liquid investment. It has been described as a "financial shock-absorber" for when emergencies strike.

Such a fund is even more essential after the death of a primary income-earner. Insurance can provide such a fund for the benefit of the survivors.

Example: Mario and Maria earn about $60,000 a year between them and live comfortably in a rural community. They know that they should have three to six months' worth of their combined incomes set aside as an emergency fund, but have never been able to amass the needed capital. To protect the interests of the survivor (should one of them die prematurely), they each have $25,000 of their personal life insurance programs earmarked to set up an emergency fund.

3. AN EDUCATION FUND

Most parents want their children to have a good education. To make certain that tuition fees and

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educational living expenses will be provided for, parents can hold life insurance on themselves, with the coverage specifically tailored to these educational needs. Life insurance guarantees that money will be available in the event that the parents do not live to fulfil their financial commitments to their children.

Depending on the number of years each child is likely to attend post-secondary school education, the graduate and post-graduate courses taken, and the location and quality of the educational institution selected, such an education fund can often run into tens of thousands of dollars per dependent child.

4. SPECIFIC FAMILY OBJECTIVES

The deceased client and his or her family members may (in life) have had specific financial or lifestyle objectives that the client did not live long enough to fulfil, but which he or she would like to be able to fulfil for the benefit of survivors.

Example: Milo and Sean had always planned to have a cottage of their own, as their summer retirement retreat, but had never been able to afford one. Although Milo is still 10 years away from retirement and expects to save the necessary $100,000 in the meantime, he also added $100,000 of term insurance coverage to his life insurance program, to ensure that Sean would have the necessary funds to fulfil their mutual dream, should Milo die before reaching retirement.

Survivors' readjustment fund

There may be a need to provide funds to permit the survivor(s) to adjust to their new situation without the deceased. For example, to replace the survivor's income for a period of time if he or she needs to take some time off work, to travel or to undergo whatever activity or assistance is required to ease the transition.

Income replacement needs

The surviving spouse and/or children may be financially dependent on the deceased and unable to generate replacement income. This could be particularly true during the dependency of children, when the emotional support of the surviving spouse may be needed, full time, at home. Life insurance guarantees that the needed funds will be available whenever the need arises.

Dependency period income for children

The dependency period runs from the time the income earner dies until children who were dependent on the deceased can pay their own way. The dependency period usually lasts until the youngest child is aged 18 or, if the children are college- or university-bound, until they graduate. Insurance money covering the dependency period can be paid out in monthly instalments to the surviving parent or guardian. The surviving parent is then better able to maintain the family home and care for the children during this critical period.

NOTE: The dependency period for specially challenged dependent children could extend decades (long after the death of the parents, even if the parents do not die prematurely), as these children frequently require financial and other support for their lifetimes.

Even when both parents work for a living, adequate dependency period income is a priority. The death of one parent might well reduce the family's income to an unacceptable level. In trying to lower the cost of maintaining the family, the surviving spouse inevitably has to reduce the family's living standards; this might, for example, entail having to move to a smaller home in a less desirable neighbourhood.

Dependency period income for a surviving partner

In most cases, there is a dependency period following the death of an income-earner within a couple, during which the survivor will require some degree of financial support:

- If the surviving spouse is employed and is financially independent, the dependency period may be as short as the readjustment period.
- If the surviving spouse is employed but can't earn enough income to replace the income reduction caused by the death, there may be a partial dependency period, during which the survivor's income must be supplemented.

Example: Ricky and Lucy earn $60,000 and $40,000 a year, respectively. They have calculated that the survivor would require 70% of their combined incomes ($70,000) a year to live on, if either of them were to die prematurely. This calculation is based on the assumption that the survivor would continue to work, earning an income at current levels. Thus, if Ricky died, Lucy would have an annual income

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shortfall of $30,000 (the $70,000 target, minus her $40,000 income) and if Lucy died, Ricky would have an annual income shortfall of $10,000 (the $70,000 target, minus his $60,000 income).

- If the surviving spouse is not employed or ceases employment after the death, the dependency period may run for the survivor's lifetime or until he or she finds employment. Even then, there may be a need for a partial dependency, if the survivor's salary isn't enough to meet his or her needs.

Of course, the nature of the dependency period for the surviving spouse or common-law partner may be significantly affected by any dependency period for surviving children.

In all of these instances, life insurance can provide capital to be invested to create the needed support for surviving dependants.

Dependency period income for parents

In some cases, children are financially responsible for their aging parents. The child may have the parents living with him or her, may supplement their retirement income or may pay for some or all of the costs of a retirement or nursing home. Life insurance can provide capital to provide for parental care and maintenance if the child dies.

Retirement income for a surviving partner

In theory, it should not be necessary to make separate life insurance provisions for the replacement of retirement income for the benefit of a surviving spouse or common-law partner. The retirement income that the deceased would have been entitled to is a function of his or her investments, government plans, employer pension plans and RRSPs. Furthermore:

- The level of retirement income required for a single surviving spouse should be less than the requirement for a retired couple.
- If the deceased was a member of government and/or private retirement plans, there would normally be residual (albeit reduced) survivor's benefits payable to a surviving spouse.
- Provisions made for the proper replacement of the deceased's income during the pre-retirement dependency period should automatically allow for the allocation of funds toward investments and RRSPs (if the survivor is working), so at least some of the couple's retirement plan would still be intact at the survivor's retirement age.

Nevertheless, it may be that the premature death of the life insured would result in a reduction of the survivor's retirement income or that the retirement income would have been insufficient in the first place. In either event, life insurance can provide the capital needed to invest (or annuitize) to generate sufficient income to offset the shortfall.

Replacement of services

It may be that a deceased partner or parent or child was providing essential services for the survivor. When such services have to be replaced, they are referred to as being "income in kind." Provision must also be made in the insurance coverage on the life of the provider to replace this form of lost "income."

Example: Rose babysits her working daughter's two-year-old son five days a week, for free. Rose expects to provide this service for another four years, until the child is in school full time. If Rose didn't provide the babysitting for free, her daughter would have to pay someone else about $400 a week for the service. If the daughter wanted to life insure Rose against the possible loss of this "income in kind," in the event of Rose's death, she should purchase about $80,000 of term life insurance on Rose's life ($400 a week for 50 weeks a year for the full four years until the child is in school).

Other personal objectives

Additionally, insurance proceeds can be used to achieve a variety of personal objectives for the estate of the deceased (estate planning):

ESTATE LIQUIDITY

Among the final expenses, a great many estate liabilities (taxes, funeral expenses, probate fees, etc.) must be paid within a short time after a death. Depending on the circumstances, these liabilities could run into tens of thousands of dollars. Few clients have this kind of cash lying around and it might be difficult for the estate to raise the needed capital in a short time.

Even if the deceased left assets that were "liquid" (easily and quickly convertible to cash), it may not be possible to convert these into cash without incurring significant losses: mutual funds may be subject to surrender charges, stocks or real estate might have to be sold when the

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market is down and so on.

For example: When Lois died she left an estate of more than $1,000,000, almost all of it tied up in real estate and high-tech stocks. Her estate had been worth $2,000,000 a year earlier, but a sharp decline in the high-tech sector of the stock market cut her net worth in half. Lois also left a demand bank debt of $100,000. With no liquid assets available and no immediate market for the real estate, Lois's executor had to sell $100,000 of the high-tech stock to pay the bank loan. The stock had cost Lois $220,000, so there was a loss of $120,000 on the sale. That loss might have been avoided if the estate had cash on hand, so that the liquidation of the stock could have been delayed until stock prices might have been more favourable.

Life insurance can provide the estate with the cash needed to meet obligations due at, or shortly after, a death. As a consequence, other assets do not need to be liquidated, or can be liquidated in due course, under more favourable conditions: after the mutual fund surrender fees have expired, when the stock market has recovered, real estate can be sold over a longer period of time for its fair market value and so on.

LEGACIES

As with final expenses, cash legacies outlined in a will usually have to be paid within the first year after death. This creates some of the same liquidity problems as with final expenses.

Additionally, many clients might like to leave specific legacies to family members (grandchildren) or to charity (a church, a medical research, the client's alma mater, etc.) but don't want to take money out of the hands of

their primary heirs to do so. Life insurance can provide the cash needed to pay such legacies without depleting the capital of the estate.

Example: Josef left an estate large enough to look after his widow, but there was no money left for his local community centre, a legacy he had always wished he could afford. Josef could have taken out life insurance to provide the $50,000 death benefit needed to pay for the legacy.

ESTATE EQUALIZATION

A client might wish to leave specific property to specific heirs, like a family cottage to be left exclusively to the only child who has shown an interest in it. However, if there are not sufficient other estate assets to leave comparable inheritances to the client's other children, there may be a feeling that the children have not been treated equitably. Life insurance can provide the cash needed to equalize the interests passing to all children.

Example: Maurice, a 60-year-old widower, owns a house worth $250,000 as well as $400,000 in other assets. He has three children and would like to treat them all equally. His two oldest children each own their own homes and his youngest is renting an apartment. He would like to leave his home to his youngest child, so she too would own her own place, but to do so would only leave $400,000 to be split between other two children – $200,000 each. Maurice is concerned that ill-will among his children would be the result if he left $50,000 more to his youngest daughter than to the other two. A simple solution would be for Maurice to take out $100,000 of life insurance on himself and split the death benefit equally between the two older children, so that each child would receive a total of $250,000 from his estate.

The taxation of death benefits

Life insurance proceeds are virtually guaranteed to be paid to the beneficiary, are usually paid within two weeks of a claim being filed and are generally exempt from the creditors of the life insured. But one of the greatest benefits that life insurance proceeds offer to the beneficiary (the person to whom they are payable) is that they are almost always received tax-free.

With the exception of proceeds from a policy registered as a retirement savings plan or a segregated fund plan, regardless of the type of insurance policy or the amount of premiums paid, death benefits are not treated as "income" to the recipient under the Canadian Income Tax Act.

Because insurance death benefit proceeds are tax-free, estate planning can be based on the gross value of the death benefit (rather than some net, after-tax value), regardless of the personal tax bracket of the beneficiary.

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Example: Katarina wishes to leave each of her two children $100,000 to help them each to buy a home when she dies. Her eldest daughter is in a 40% income tax bracket and her youngest daughter is in a 25% income tax bracket. If Katarina takes out a $200,000 life insurance policy on herself and leaves the proceeds equally to the two daughters, she won't have to worry about what the after-tax value of the gift to each daughter would be: the proceeds will be received tax-free and will be worth $100,000, net, to each daughter.

The role of life insurance with capital gains and registered plans

One of the most common types of personal liability provided for through the use of life insurance is income tax payable at death. (See Final Expenses, above.) This tax liability may, in part, consist of regular unpaid income taxes owing as of the date of death, but the largest portion of taxes owing at death can usually be attributed to registered plans owned by the deceased taxpayer and/or capital gains on certain properties owned by the deceased.

TAX ON CAPITAL GAINS AT DEATH

Under the Canadian income tax system, the gain (the difference between the acquisition cost and the disposition proceeds, if any) incurred on the sale of most types of property is treated as a capital gain. At present, 50% of any such net capital gain (capital gains minus capital losses) is included in the taxpayer's income for the year.

Example: Leilani purchased 100 shares of ABC Corp. for $22 each, for a total cost of $2,200. She sold the shares in 2011 for $35 a share, or $3,500. Her capital gain on the transaction was $1,300 ($3,500 - $2,200). If this was the only transaction that Leilani entered into in 2011 that generated a capital gain or loss, the $1,300 capital gain would be her net capital gain for the year and she would be required to add $650 to her taxable income for 2011 (50% x $1,300) as a consequence.

In addition to the rules relating to actual dispositions of property (sales, gifts, etc.), the Income Tax Act also provides that a taxpayer is deemed to have disposed of his or her capital property owned at death for proceeds equal to its fair market value at that time. Any resulting net capital gain or loss must be reported on the taxpayer's personal income tax return for the year of death.

Example: John died on March 22, 2011, owning a cottage property with a fair market value of $120,000 and a tax cost (adjusted cost base) of $80,000. John is deemed to have disposed of the cottage for its fair market value of $120,000 and a capital gain of $40,000 will be attributed to him for 2011. As a result, $20,000 (50% x $40,000) would be added to John's income on his terminal tax return to his date of death.

In cases where the capital property in question is "rolled" tax-free to a surviving spouse or common-law partner, the net gain will not be taxed in the hands of the first spouse/partner to die, but will be deferred and taxed to the surviving spouse/partner when he or she dies or otherwise disposes of the property.

TAX ON REGISTERED PLANS AT DEATH

In the case of registered retirement savings plans (RRSPs) or registered retirement income funds (RRIFs), under the Income Tax Act the taxpayer is deemed to have disposed of the plan at death for proceeds equal to the fair market value of its assets and must include the value of those assets in his or her income for the year of death.

Example: Maury owned an RRSP with $225,000 worth of stock in it at the time of his death on April 19, 2011. Since Maury died without a surviving spouse or common-law partner to whom to "roll" the proceeds of the RRSP tax-free, $225,000 had to be added to Maury's income for 2011.

In cases where the proceeds of an RRSP or RRIF are "rolled" tax-free to a surviving spouse or common-law partner, the value of the plan will not be taxed in the hands of the first spouse/partner to die, but will be deferred and taxed to the surviving spouse/partner when he or she dies, or otherwise receives or is deemed to receive the proceeds of the plan.

WHERE THERE IS NO TAX-FREE ROLLOVER

If the tax-free rollover does not apply, the tax liability will be payable in the hands of the plan or property owner at the time of his or her death.

To provide for the estimated liability, life insurance should be placed on the life of the owner in the amount of the expected tax payable.

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WHERE THE TAX-FREE ROLLOVER APPLIES

In circumstances where the tax-free rollover applies (i.e., the capital property or registered plan is left to a surviving spouse or common-law partner), there are no tax ramifications at the time of the first death; all tax consequences are deferred until the time of the death of the surviving spouse/partner. As a result, all of the tax liability accruing during the ownership of both parties will be taxed in the hands of the last one to die.

Example: Jack purchased 1,000 shares in the ABC Corp. for $10 each in 1990, for an adjusted cost base (ACB) of $10,000.When Jack died in 1998, the shares were worth $14 each, or $14,000. Since the shares were left to Jack's legal spouse, Jill, the $4,000 capital gain did not have to be reported on Jack's terminal income tax return. Instead, Jill "inherited" Jack's $10,000 ACB on the shares. When Jill died in early 2011, the ABC shares were worth $20 each. Since Jill died without leaving a surviving spouse or common-law partner, she was deemed to have disposed of the shares at her death for proceeds of $20,000 and the entire gain since Jack purchased the shares ($10,000) would be reported on Jill's terminal income tax return.

Because the tax liability is not reportable until the second death, there is no need to provide cash to pay the liability until the time of the second death. As noted below, it is possible to buy a life insurance policy on the lives of two or more persons, with only one death benefit payable, and that is payable at the time of the last death only. Nothing is payable at the time of the first death among the lives insured.

Example: In the example above, there would be no tax payable at the time of Jack's death, but the whole $10,000 of gain would be reportable at the time of Jill's death. Since the life insurance agent has no way of knowing whether Jack or Jill would die first, life insurance would be placed on both lives, so that the proceeds would be available at the exact time when the tax liability becomes payable. This could be accomplished by taking out joint-last-to-die life insurance on both Jack and Jill.

Multiple life insurance policies

Most life insurance policies (both term and permanent) insure only one person's life and pay only one death benefit.

Some policies (such as universal life insurance) may insure more than one life, but they insure each life separately and pay out a separate death benefit at the death of each and any of the lives insured.

Example: Under the terms of Jose's universal life insurance policy, taken out in 1998, Jose was insured for $200,000, his wife Maria was insured for $150,000, and their son Felix was insured for $25,000. In 2000, Jose died in a hunting accident. The $200,000 death benefit was paid to Maria and the policy remained in force, still covering Maria and Felix. In early 2011, Maria was killed in an automobile accident; the $150,000 death benefit was paid to Maria's estate and the policy remained in force, covering Felix.

Each coverage under a multiple lives policy is administered separately.

Alternatively, both term and permanent life insurance policies can be issued on a joint basis: still insuring the lives of more than one person, but paying out only one death benefit, either at the time of the first death or the last death of the lives insured.

Joint first-to-die life insurance

A joint first-to-die life insurance policy places one level of coverage on the lives of two or more persons, but only pays out a death benefit once, at the time of the death of the first person to die among the lives insured. The contract is most commonly used in situations where there is a liability (often a debt) associated with two or more people and there is a desire to ensure that insurance proceeds will be available to discharge the obligation at the time of the first death among the lives insured.

Case #1: Rob and Janet are a common-law couple who have been together for 12 years, have one child and own a home in suburban Winnipeg. The house has a $90,000 mortgage. Both Rob and Janet work and each would like the comfort of knowing that, should his or her partner die prematurely, the survivor and the couple's son would be able to continue to live in their home, free of a mortgage. They take out a joint first-to-die term insurance policy covering both their lives, with the death benefit to be paid to the survivor should one of them die. Only one death benefit is required, since the mortgage

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will be discharged at the time of the first death.

Case #5: Rob is in an equal business partnership with his brother Dick. The business is estimated to be worth $500,000. The brothers have a buy-sell agreement that provides that, in the event of the death of either of them, the surviving brother must buy out the deceased's business interest for $250,000. To fund the agreement, Rob and Dick have taken out a joint first-to-die term insurance policy on both of their lives, with the death benefit to be paid to the survivor at the time of the first death. Only one death benefit is required since, after the buyout, the surviving brother will own all of the business and will have no further obligations under the buy-sell agreement.

Joint first-to-die policies are often used in these situations because they are somewhat less expensive (in terms of premiums) than providing an equal amount of life insurance coverage on each of the lives insured separately. The policies are not substantially less expensive than separate policies, however, because, actuarially any two persons have a shorter joint life expectancy on a joint first-to-die basis than either of the persons does individually.

In most cases, joint first-to-die policies expire after paying the death benefit. This makes sense, since the coverage is no longer required. Some policies, however, offer the surviving life insured the option to continue an equal amount of coverage on his or her own life under a separate policy, without having to provide medical evidence of insurability. The survivor usually has about 30 days after the first death in which to decide whether to exercise the conversion option. Coverage on the survivor remains in force during this 30-day conversion period. Of course, an additional premium is charged for this conversion option.

Joint last-to-die life insurance

More frequently, life insurance is purchased on a joint last-to-die basis. A joint last-to-die life insurance policy places one level of coverage on the lives of two or more persons, but only pays a death benefit once, at the time of the death of the last person insured. The contract is most commonly used in situations where there is a liability (often an income tax liability) associated with two or more people and that liability will become payable only at the time of death of the last person to die.

Case #1: Bart and Bonnie are a married couple, both age 53, who own a mortgage-free home, a cottage with an unrealized capital gain of $180,000 and (between them) $240,000 in RRSPs. At the time of the first death between Bart and Bonnie, no income tax needs to be paid on either the capital gains on the cottage or the proceeds from the RRSPs, since these assets can be "rolled" tax-free to the surviving spouse.

However, at the death of the surviving spouse, about $150,000 in tax will be payable on these assets. Bart and Bonnie decide to fund that tax liability by purchasing a $150,000 joint last-to-die policy on their own lives. When they are both gone, the full value of the cottage and the RRSP proceeds can pass to their children on a tax-paid basis.

Case #5: Bart and Bonnie have reciprocal wills, leaving everything they own to each other and then, at the last death, providing for a $50,000 legacy to their alma mater (they met and became engaged at university) and for the rest of their estate to pass to their children. Rather than deplete the assets passing to their children by the amount of the legacy, Bart and Bonnie decide to fund the legacy to their alma mater by purchasing a $50,000 joint last-to-die life insurance policy on their own lives, payable to the estate of the last of the two to die.

Joint last-to-die policies are often employed in these situations because they are much less expensive (in terms of premiums) than providing an equal amount of life insurance coverage on each of the lives insured separately. Actuarially, any two persons have a much longer joint life expectancy on a joint last-to-die basis than either of the persons does individually. For example a 55-year-old male with a 23-year life expectancy and a 54-year-old female with a 29-year life expectancy might have a joint life expectancy of somewhere in the range of 35 years.

Joint last-to-die policies are more likely to be permanent (that is, whole life) contracts than term insurance, because most term policies are likely to expire (at age 65 or 75, for example) prior to the last death of the lives insured.

Usually, the first death of the lives insured under a joint last-to-die policy has no impact on the policy and the premium remains unchanged. The coverage remains in force until the death of the last life insured. Some policies do, however, (for an extra premium) provide that all future premiums regularly scheduled under the policy will be "waived" after the first death.

Joint policies are most frequently purchased on the lives of two persons (spouses, common-law partners, business

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partners, etc.), but can be placed on the lives of more than two people (shareholders of a private corporation, for example).

Section summary

You should now be able to:

- Identify the personal needs met by life insurance products.
- Explain the tax-favoured treatment of the proceeds of a life insurance policy to the policy beneficiary.
- Explain the benefits of using life insurance proceeds to help defray the capital gains taxes triggered by death.
- Explain multiple-life insurance plans.

5:2 BASIC LIFE AND HEALTH INSURANCE PRODUCTS

The following outlines the basic life and health insurance products available on the market and provides a brief outline for each product type.

Product	Definition / Description
Life Insurance	Insurance that pays a lump-sum death benefit to the estate, or to the named beneficiary, at the death of the individual upon whose life the policy is based (the life insured).
Disability Insurance	Insurance that pays a periodic (usually monthly) income benefit, or a lump-sum, to the beneficiary (usually the life insured), provided the life insured meets the policy definition of "disabled" and is unable to work due to illness or injury. The benefit is payable for the duration of the disability or for the benefit period described in the policy, whichever is less.
Group Insurance	Insurance coverage (life, disability, health insurance, etc.) covering a pool of individuals who are affiliated, usually through their employer. The group insurance policy provides individual protection on each member, under one master contract, often at premium rates much lower than could be obtained for individual policies. Group insurance contracts are usually issued without the members having to provide medical evidence of insurability.
Annuities	An annuity is a contractual arrangement whereby the policyowner pays a sum (the premium – paid either as a lump sum or in instalments) to an insurance company in return for a stream of guaranteed income payments. The income payments may start immediately or may be deferred some months or years. The payments may be made for a fixed period of time, like 10 years (a fixed-term annuity) or may be based on duration of the life of the person on whose life the annuity is based (a life annuity).
Segregated Funds	A pool of assets held in trust by a life insurance company as the underlying investment for a series of life insurance and/or annuity contracts. Assets held in a segregated fund are separate from the assets of the life insurance company itself and do not form part of its equity.

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LIFE INSURANCE PRODUCTS

Product	Definition / Description
Critical Illness Insurance	Insurance that pays a lump-sum benefit to the insured in the event that he or she suffers a life-threatening illness, injury or medical condition (such as a heart attack, stroke or cancer) and survives. The insured does not have to provide proof of loss, only that he or she has the covered medical condition.
Accident and Sickness Insurance	Insurance that pays a benefit should the insured suffer an illness or injury. Common types of this insurance are health policies that provide reimbursement for medical and dental costs and travel policies that pay medical and related expenses for the insured in the event of illness or injury while travelling outside Canada. These plans cover only the expenses that are not covered under provincial health plans.
Long-term Care Insurance	Insurance that provides reimbursement for expenses incurred for hospital, nursing home or home care to assist the insured with basic needs. The need for care could be due to accident, illness, mental illness, old age or other causes.
Travel Insurance	Insurance that pays medical and related expenses for the policyowner in the event of illness or injury while the policyowner is travelling outside of Canada.

The following cases illustrate circumstances where one or more of these products might be required to meet clients' risk management needs:

Case # 1: Conrad is the majority shareholder of a Canadian-controlled private corporation, Argot Inc. He spends a great deal of time working and his efforts are crucial to its continuing success. At age 45, he is in good health and very active both in his business and in his personal life. He is concerned about the fate of the business if he dies or becomes disabled.

What can he do to address his concerns?

Answer: The risks facing Conrad are that he might die prematurely or become disabled and unable to work at his business for a long period of time.

Since his early death would cause a disruption in business income, a life insurance policy with the business as owner and beneficiary would provide funds to keep the business going while a replacement was found or the business was sold. The size of the policy could be based on an estimate of Conrad's financial worth to the business.

Conrad is also a candidate for disability income insurance. Again the company could own a disability income policy with Conrad as the insured. If he were to become disabled and to qualify for benefits under the plan, the company would receive periodic payments during his disability to offset the income lost because Conrad was unable to work in the business.

Case #5: Erica is a well-established executive with a large public corporation. In addition to a six-figure annual salary, she is a member of the company's group insurance plan that provides her with excellent life, health and disability coverage. In her personal life, she is committed to supporting a women's shelter with significant contributions each year. She has provided for the shelter in her will if she dies, but she is concerned that if she suffers a debilitating illness, she will not have the resources to continue supporting the shelter.

How can she address this concern?

Answer: Since Erica's risks of dying prematurely and becoming disabled are addressed through her group insurance plan, she may want to consider a critical illness plan that will pay her a lump sum amount should she suffer a severe and life threatening illness.

While her disability insurance would provide her with a regular income to replace her salary, at least in part, she may not have the resources to continue to support her charitable efforts. A critical illness policy would provide a pool of money to allow Erica to meet her personal life commitments.

Case #3: Candace is the sole proprietor of a florist shop that she has developed into a successful business over the past five years. Candace and three staff operate a very busy enterprise. At age 35, she is in good health and

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works very hard to keep the business going.

Recently, the shop owner next door to her suffered a heart attack. His family could not continue to operate the business and it had to be closed. Candace worries that she might suffer an illness or injury that would prevent her from working in her business for long enough to jeopardize its existence. How can she address this concern?

Answer: Candace's major concern might be addressed with disability income insurance and a special form of it: business overhead expense. This type of insurance is intended to provide funds to pay for the regular expenses of the business up to the limits of the policy.

She can also consider disability income insurance that could replace the revenues she earns for the business.

Case #4: Declan and Siobhan emigrated from Ireland to Canada 20 years ago, just after they were married. While they have friends in their community, they have no relatives in Canada and their children have moved away. As they approach retirement age, they are looking forward to spending their retirement doing the things they enjoy.

Recently, they were disturbed, however, when an elderly neighbour whom they assisted from time to time was diagnosed with Alzheimer's disease and had to be placed in a nursing home. To pay the costs, the neighbour's home was sold and all of her assets were assigned to cover the costs.

What actions might the couple take now to address the issue of their personal care later in life?

Answer: The couple may have enough resources to enjoy their retirement years. If, however, one or both of them should fall ill and require close care either at home or in a nursing facility, it may be prudent for them to consider the benefits of long-term care insurance in order to make sure that the care they might require does not drain all of their resources.

Section summary

You should now be able to:

- Select the most appropriate insurance product type, given specific circumstances.

5:3 POLICY PROVISIONS

In Canada, life insurance contracts issued in the common law provinces and the territories are governed by the terms and conditions of the so-called Uniform Life Insurance Act. Quebec has not adopted the act, but has life insurance legislation that is very similar to it.

Among other things, the act mandates that all life insurance policies shall extend certain rights to the policyowners and impose certain obligations on the issuers of life insurance. Statutorily, these life insurance policy provisions are enforceable regardless of whether they are actually included in the wording of the life insurance policy.

In general, these provisions deal with such matters as:

- The definition of the "entire contract."
- The right to rescind the contract.
- A suicide clause.
- Material misrepresentations.
- An incontestability clause.
- Fraudulent misrepresentations.
- The premium grace period.
- Reinstatement provisions for a lapsed or cancelled contract.
- Misstatement of age or sex.
- Smoking status.
- Settlement options.
- Beneficiaries.

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- Policy assignments.

ENTIRE CONTRACT

The entire contract provision stipulates those documents that form the contract of insurance between the insurance company and the insured. Typically, this will include:

- The life insurance policy itself.
- The application for insurance, a copy of which is usually attached to the policy.
- All and any riders.
- Any ancillary documents that may be identified under the policy.

Example: Tobias applied for a life insurance policy with the All Canada Life Co. During the underwriting process, it was uncovered that Tobias was both a skydiver and the pilot of a private seaplane. All Canada agreed to underwrite the policy but added exclusionary clauses in a supplement to the policy, stating that no death benefit would be payable in the event that Tobias died in a skydiving accident or that he was killed in a crash of his private plane. The application form, the issued policy and the exclusion supplement make up Tobias' entire contract with All Canada.

The purpose of the entire contract provision is to provide certainty for the parties involved as to the terms and conditions of the insurance contract (that is, neither party can be bound by extraneous oral or written agreements or conditions).

THE RIGHT OF RESCISSION

Owners of newly issued life insurance contracts are offered the guaranteed right to examine their new contract, once it has been received, to determine whether they wish to keep it. The owner has 10 calendar days after policy delivery to either decide to keep the policy by default – by saying nothing to the contrary to the life insurance company – or to return it to the life insurance company, advising the company that the owner wishes to rescind (void) the contract.

If the policy is rescinded, the applicant will be fully reimbursed for all and any premiums paid to the date of rescission and the contract will be cancelled.

The right of rescission is also sometimes referred to as the “10-day free look” period.

It’s important to remember that the 10-day free look period starts on the day on which the policy is actually received by the applicant, not on the issue date of the policy. If you delay delivering the contract, you are inadvertently extending the time frame when the applicant can rescind the contract.

Example: Marsha was a busy life insurance agent; successful in that she sold a lot of life insurance contracts. Unfortunately, Marsha’s sales activities took up most of her work time and got in the way of her attention to her administrative duties, duties like policy delivery. Marsha sold a policy to Mrs. Johnston in January 2011, and the contract was approved and issued and delivered to Marsha in early March. Marsha was extremely busy at the time and set the policy aside in her desk drawer and forgot about it.

Six months later, looking for a file, Marsha stumbled across Mrs. Johnston’s policy and decided that it was time for her to deliver it. Unfortunately for Marsha, Mrs. Johnston had read about other, more attractive life insurance policies in the meantime. Because of her interest in the other products and her unhappiness with Marsha’s delays, Mrs. Johnston decided to exercise her right of rescission and refuse the policy when Marsha finally did deliver it in September.

Even though the premiums had been paid monthly since January and even though the policy had been in force for almost nine months (the insurance company would have paid the death claim had Mrs. Johnston died in the interim), Mrs. Johnston was legally entitled to rescind the policy and get all of her premiums refunded.

The policyowner can, of course, unilaterally cancel the policy at any time, but if the cancellation takes place after the end of the rescission period, the policyowner is not entitled to a refund of premiums paid.

SUICIDE CLAUSE

One of the “miracles” of life insurance is that it is possible for a very small premium deposit to be translated into a death benefit that may be hundreds, or thousands, of times larger. In extreme examples, clients have taken out life insurance, paid only the first month’s premium and then died, leaving their beneficiaries with hundreds of

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thousands, or millions, of dollars in tax-free death benefits.

Of course, the potential for this type of extreme leveraging opens the door to the possibility of planned abuse. Emotionally distraught individuals, particularly those who are concerned over personal financial difficulties, may perceive that a combination of suicide and life insurance could be the solution to all of their problems. Suicide will relieve them of their personal burdens and, if they insure their lives heavily, the life insurance death benefits will relieve the financial burdens of the dependants that they leave behind.

To protect themselves against this type of anti-selection, insurers include a suicide clause in their life insurance policies, stipulating that no death benefit will be payable in the event that the life insured commits suicide within a specified period (usually two years) from the issue date (or reinstatement date) of the contract.

In the event that it can be established that the life insured in fact died by suicide within this two-year period, the only "benefits" payable under the life insurance contract will be a return of the insurance premiums paid to date, usually without interest.

Example: Eloise took out a term life insurance policy for $250,000 on her own life to protect a business start-up loan that she had taken out with the bank. Eighteen months later, due to a change in the tastes of the buying public, Eloise's dream of independence was in tatters and her business was on the verge of bankruptcy. Despondent, Eloise committed suicide. As a consequence of her suicide within 24 months of the policy issue date, no death benefit was payable under the term insurance policy (other than a refund of premiums) and the bank loan remained a liability of Eloise's estate.

MATERIAL MISREPRESENTATIONS

Life insurance contracts are contracts of utmost good faith – the insurer relies heavily on the veracity of the applicant's statements and information given in the application process. Because of the importance of this reliance on the applicant's veracity and complete disclosure of material information, the insurer may have the right to avoid (cancel) the policy if it turns out that the insured made a false or misleading statement (a material misrepresentation of the facts) in the application process.

Such misrepresentations are considered to be material if the insurer would have modified or refused to issue the insurance coverage provided, had it known the truth.

Some misrepresentations may be inadvertent and/or insignificant. These are not considered to be material misrepresentations.

Example: Ranjit regularly deals with two physicians, Jane and John Smith, who operate a joint practice and who often cover off each other's patients if one or the other is not available. When Ranjit was asked, on a life insurance application, for the details of his last visit to the doctor, he stated that he had visited Dr. John Smith in November of 2007 for a flu shot. After following up on Ranjit's medical file (for other reasons), the insurance company discovered that the November appointment had in fact been carried out with Dr. Jane Smith, who was covering off for her husband while he was on an emergency call. Although Ranjit's statement about the doctor's appointment was a misrepresentation of the facts, it was not a material misrepresentation. The outcome of Ranjit's misrepresentation did not affect the insurance company's underwriting decisions, so it could not avoid the contract by reason of misrepresentation.

Material misrepresentations are those misrepresentations that touch on facts that are integral to the life insurance company's underwriting process.

Example: In completing an application for life insurance, Sergei was asked by his life insurance agent (as part of the non-medical questionnaire) whether he had ever experienced any blood diseases or other problems with his blood. Sergei answered "no" to the question, completely forgetting the time that he had been treated for jaundice while he was in the army. The year after his policy was issued, Sergei experienced a recurrence of the jaundice and ultimately died from associated complications. It turned out that Sergei's earlier condition was pernicious and subject to repeated, sporadic breakouts. Had the life insurance company been aware of the nature of Sergei's condition at the time of his application, it would have either declined to issue him an insurance policy or would have rated him heavily for premiums. Although inadvertent, Sergei's failure to

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mention his previous bout of jaundice was a material misrepresentation of the actual acts of his health history. The life insurance company successfully denied the death claim under Sergei's policy.

INCONTESTABILITY CLAUSE

So that the applicant/insured does not have the validity of his or her life insurance coverage left open to challenge indefinitely, a life insurance company cannot avoid a contract for reason of a material misrepresentation (except in the case of a fraudulent misrepresentation) after two years has passed from the date (or reinstatement) of issue of the life insurance policy.

Example: In the above example, had Sergei lived for three years after this date of the policy before the recurrence of his jaundice (and before the insurance company discovered his inadvertent misrepresentation), the insurance company would have been denied the right to avoid the contract under the two-year incontestability clause.

FRAUDULENT MISREPRESENTATIONS

A fraudulent misrepresentation occurs if the applicant for a life insurance policy intentionally provides the insurance company or its agent with false information, or intentionally fails to disclose information, with the intent to mislead the insurance company into issuing a contract of insurance when it might otherwise not do so.

In the event of fraudulent misrepresentation on the part of the insured/applicant, the insurer may have the right to avoid the insurance contract, without restriction as to time limits.

Example: Strongly suspecting that he was terminally ill with stomach cancer and hoping to provide for his family, Marcus applied for life insurance with the Acme Life Insurance Co. and intentionally gave false answers to the questions on the medical questionnaire dealing with stomach complaints. The insurance policy was issued as applied for. Three years later, Marcus died of cancer. Upon investigation, Acme found out that the type of cancer from which Marcus died was slow progressing and produced significant side effects. It became apparent that Marcus must have been suffering from the disease at the time that he applied for the policy and must have experienced serious stomach complaints as a result (an interview with family members verified this fact).Acme was able to deny the insurance claim on the basis of fraudulent misrepresentation – that Marcus must have concealed his symptoms from the insurer with the express intent of inducing the company to issue a policy on his life.

Of course, the insurance company also always has the option of ignoring the misrepresentation and leaving the policy in place as issued or paying the claim, as the case may be.

GRACE PERIOD

Life insurance (as well as accident and sickness) policies contain a grace period (usually 30 days) during which the policy remains in force, even if a renewal premium that is due has not been paid. Should the life insured die during this grace period, the policy death benefit would still be payable, less the outstanding premium due.

Example: Miguel received an annual premium notice on his $1,000,000 term to 100 life insurance policy, for the premium due on July 15, 2011. He left on a lengthy sailing vacation the day after, having forgotten to pay the premium of $2,500. On Aug. 5, Miguel's sailing sloop was capsized in a summer storm and Miguel drowned. Even though the current year's premium had not been paid, Miguel's policy remained in force for 30 days after July 15, because of the application of the grace period provision. Miguel's beneficiary, his widow, received the full proceeds of $1,000,000, less the outstanding premium due of $2,500.

The grace period does not apply to the initial premium paid under a life insurance contract; the contract is not valid until such time as the initial premium is paid. However, all renewal (subsequent) premiums due are subject to the grace period. The rationale behind the existence of the grace period is that the insured should not be unduly penalized (the potential loss of thousands, or millions, of dollars of life insurance death benefits) for a relatively small transgression (the delay in payment of a premium due).

Provided the premium due is paid within the grace period (without penalty or interest), the policy will continue in force. The grace period applies to each premium due; it is not, for example, invoked only once

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during the lifetime of the policy.

At the expiration of the grace period, if the premium due remains unpaid, the policy will either lapse or the insurer will invoke one of the policy non-forfeiture provisions.

NOTE: In the case of a universal life contract, where there may be no contractually scheduled premium payments due in a specified amount and/or at a specified time, the grace period will only come into effect if the net cash surrender value of the universal life insurance policy is insufficient to support the monthly deductions for expenses and mortality under the contract.

REINSTATEMENT

In the event that a life insurance policy should lapse, for want of premiums, or be continued in force under one of the non-forfeiture options, the contract will normally contain a provision offering the insured the chance to reinstate (put back into force) the policy as it was previous to the date of termination. However, the policy usually cannot be reinstated if it was surrendered by the policyowner for its cash surrender value.

When a policy is reinstated, the insured does not receive a new contract, but, rather, the original policy is placed back in force, with its original issue date, as though there had never been any interruption in the full benefits (including cash values) of the policy. In the case of a reinstated policy, however, the suicide and incontestability periods start anew as of the reinstatement date.

The Uniform Life Insurance Act requires that the reinstatement provision must be available to the insured for at least two years from the date of policy lapse, etc., but this timeframe may be expanded at the insurer's discretion (reinstatement periods of up to five years are not uncommon).

To reinstate a life insurance policy, the insured must:

- File an application for reinstatement with the insurer within the prescribed time period.
- Provide satisfactory medical evidence of insurability of the life insured under the policy.
- Pay all regularly scheduled premiums normally payable between the date of lapse and the date of reinstatement, with interest.

Given that the requirements to reinstate a policy are at least as rigorous as the requirements to initiate a new policy, in addition to the need to pay the insurer all "missed" premiums, you might wonder why the insured wouldn't simply choose to let the "old" policy remain lapsed and simply apply for a new contract. The main advantage of reinstatement is that the premiums under the reinstated policy will be based on the attained age of the life insured at the time the original policy was issued. Premiums under a new contract would be based on the life insured's current attained age. It may be advantageous, from the standpoint of total premiums payable, to restart (reinstate) the old policy, depending on:

- The premium difference between the old policy and any new policy that would be purchased to replace it.
- The number of premiums that have to be repaid to the insurance company under the reinstatement.
- The number of premiums that the policyowner expects to have to pay for as long as the policy is available or needed, or until the death of the life insured.

Example: Herman was paying $700 a year for a $100,000 term to 100 policy that he acquired 12 years ago. Late last year, Herman suffered severe financial difficulty and was unable to pay his insurance premium. As a consequence the policy lapsed. Herman's situation improved substantially and he would like to reacquire his insurance coverage. He is in excellent health and, because he is now older, a new term to 100 policy would cost him $1,250 a year for the rest of his life. He would be able to repay his lapsed policy simply by paying about $400 in back premiums, plus interest for several months at 6%. If he reinstates the lapsed policy, the premiums from this point forward, for life, would only be the original $700 a year. Obviously Herman would be better off by taking advantage of the reinstatement provision under his old policy.

MISSTATEMENT OF AGE OR SEX

In the event that the insured should misstate (misrepresent, in error or on purpose) the age or the gender (less likely) of the life insured at the time of application, the misstatement of age or sex provision permits the insurer to adjust the face amount of coverage provided under the policy to the amount that would have been provided at policy issue had the correct age or sex of the life insured been utilized to calculate the policy premium.

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If the misstatement is discovered prior to the death of the life insured under the policy, the insurer may adjust the face amount of coverage or may choose to give the insured the option of keeping the amount of coverage the same as at issue and either receiving a refund of "overpaid" premiums to date (if the age of the life insured had been overstated) or to pay the insurance company the "underpaid" difference in premiums since the inception of the policy (in the case of an understatement of age). The insured can then continue paying the correct premium for the amount of coverage provided from this point forward.

Example: Monica was in the habit of telling everyone that she was 34 years old (when in fact she was actually 37). In fact, the habit became so ingrained that she accidentally gave her age as 34 when completing a life insurance application last year.

Based on her stated age of 34, her insurance premium under the plan she wanted was $4.40 per $1,000, or $440 a year for the $100,000 of insurance that she had applied for.

Unfortunately, Monica died in an automobile accident just six months after taking out the insurance policy. In reviewing Monica's documentation, in the course of processing her death claim, the insurance company discovered her true age.

Based on her actual attained age of 37 at the time of the life insurance application, Monica's premium should have been calculated at a rate of $4.95 per $1,000 of face amount of coverage. Accordingly, the insurance company adjusted the death benefit on Monica's policy from $100,000 to $88,889 [($4.40/$4.95) x $100,000] and paid the adjusted amount to her beneficiary.

If this misstatement of age is discovered at time of death claim, the amount of insurance proceeds paid out will be adjusted accordingly.

SMOKING STATUS

In the event that an applicant for life insurance should misrepresent himself or herself to be a non-smoker rather than a smoker (within the life insurance company's express definition of a "smoker"), this may constitute a fraud against the insurer and the life insurance company has the right to deny a claim under the contract and refund the insured's premiums paid to date.

It is important that when completing the application, you read the "smoker" question carefully and fully to the applicant and record the applicant's answers accurately. If appropriate, you should reference both the applicant's answers and your own observations and/or personal knowledge of the applicant.

Insurance companies have been using sophisticated methods (saliva tests, for example) to detect whether or not applicants are smokers. Also, many life insurance companies monitor the business submitted by agents, to determine whether a higher than average number of non-smoking applications are being submitted. If so, the agent's future business will be scrutinized very carefully.

If the misrepresentation is discovered during the insured's lifetime, the insurance company reserves the right to cancel the policy and refund the insured's premiums paid to date, to increase the insured's premiums (retroactive to the inception of the policy) or to decrease the amount of the insured's coverage to the level of coverage that the premium paid would have supported, as at the time of application, had the applicant been properly identified as a smoker.

SETTLEMENT OPTIONS

The policyowner has the right, under the terms of the insurance contract, to pre-select the manner in which the insurance proceeds will be paid out to the beneficiary (a settlement option).

The standard options available are:

- lump sum;
- interest only;
- fixed period;
- fixed amount, and
- life income.

In the absence of any instructions from the policyowner, the standard default settlement option is the lump-sum option.

Generally, if the policyowner preselects a settlement option

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(either at time of application or at any other time during his or her lifetime), the option chosen is irrevocable:

- An irrevocable settlement option is binding on the beneficiary and cannot be changed by him or her at any time.

The purpose of making the settlement option "irrevocable" is to place restrictions on the beneficiary's use of the policy proceeds.

However, an irrevocable settlement option can always be changed by the policyowner during his or her lifetime. The irrevocable restriction only applies to the plan's beneficiary.

Lump-sum option

By far the most common settlement option is for the beneficiary to receive the death benefit proceeds as a single, lump-sum payment.

Example: When Olivia died, she owned a $25,000 whole life non-participating life insurance policy on her own life, with her daughter, Felicity, named as the beneficiary. Olivia had not pre-selected any settlement options for the death benefit. Felicity elected to receive the $25,000 proceeds of the policy in a lump sum.

The lump-sum proceeds are usually paid directly to the beneficiary by cheque, although some insurance companies will offer the beneficiary the option of having the funds deposited into a "chequing account" with the insurer, from which funds can be drawn at the beneficiary's discretion.

All of the settlement options other than lump-sum involve situations where the insurance company (initially, at least) retains the insurance proceeds in its possession, invests them and distributes them to the beneficiary(ies) over time.

Interest option

The interest option provides for the insurer to hold and invest the insurance death benefit proceeds in an interest-bearing long-term deposit. The contract normally stipulates a minimum rate of interest (for example, 4%) at which the funds will be invested. The policyowner names two classes of beneficiary for the proceeds: a primary beneficiary and a secondary (or residual) beneficiary. The interest earned on the deposit is paid out to the primary beneficiary (usually on a monthly basis) for the duration of his or her lifetime. This income is taxed in the hands of the primary beneficiary. At the death of the primary beneficiary, the deposit investment is surrendered and the capital, plus any undistributed income, is paid to the secondary beneficiary.

Example: Germaine owned a life insurance policy with a face amount of coverage of $100,000. As the settlement option under the contract, Germaine had chosen the interest option, naming her husband, Hans, as the primary beneficiary and her children as the secondary beneficiaries. When Germaine died, the $100,000 insurance proceeds were invested by the life insurance company, in a long-term 7% term deposit account. Each year, for the duration of his life, Hans was paid (and taxed on) $7,000 of interest income. At Hans' death, the $100,000 insurance proceeds were paid out to the couple's children.

Similar to the rationale behind the use of a life trust, the interest option is most often employed where the policyowner wishes to provide a lifetime income benefit to one beneficiary (often a spouse), while assuring that the principal from the death benefit will remain intact to pass to other beneficiaries (usually the children).

OTHER SETTLEMENT OPTIONS

The last three settlement options are directed at generating a guaranteed income for the policy beneficiary, while keeping the investment responsibility for the funds in the hands of the insurance company. The amount of the payout will depend on the amount of the insurance proceeds, the term of the period and the investment rate earned by the insurance company on the invested proceeds. The insurance policy will normally contain a schedule of guaranteed minimum payments, expressed as a function of the number of years in the period selected and the number of thousands of dollars of insurance proceeds (for example, a guaranteed minimum monthly payout of $21.50 per $1,000 of insurance proceeds for a five-year period).

The primary focus of all three options is to produce income for the primary beneficiary, with little, or no, provision to provide a residual benefit for secondary beneficiaries.

Fixed-period option

Not surprisingly, the fixed-period settlement option provides for a level stream of payments to the beneficiary

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for a fixed period of time.

Example: If Olivia, above, had selected a fixed-period settlement option of 10 years for the $25,000 proceeds of her life insurance policy, at her death, the life insurance company would have invested the $25,000 and paid it to Felicity (the beneficiary) in 10 equal instalments of $2,500, plus interest.

The fixed period option is most appropriate when the policyowner feels that the beneficiary does not have the expertise to invest the insurance proceeds himself or herself and will only need the proceeds for a fixed period of time (for example, until schooling is complete or until retirement).

Fixed-amount option
The fixed-amount option provides a predetermined, level stream of income for the primary beneficiary for as long as the insurance proceeds can support the income stream. Once all of the capital and any associated investment income are exhausted, the income stream to the beneficiary terminates. The duration of the term of interest payments will be a function of: the fixed amount of income specified under the contract, the amount of the death benefit proceeds and the amount of income generated when the insurance proceeds are invested (by the insurance company) on behalf of the beneficiaries.

Example: Benny selected a settlement option for the death benefit proceeds of his insurance policy of a fixed benefit of $500 per month, for as long as the proceeds and investment income generated by the proceeds would last. As it turned out, in this case, Benny's beneficiary received payments of $500 a month for 17 years and 11 months.

Should the primary beneficiary die before the principal portion of the insurance proceeds is exhausted, any residual funds will be paid in a lump sum to secondary beneficiaries.

Life income option
In effect, the insurance company uses the insurance proceeds to acquire a life annuity, based on the life of the primary beneficiary. This annuity may, or may not, offer a guaranteed number of payments, depending on the terms and conditions of the contract.

If there is no guarantee and the annuity is a straight life annuity, income will be paid to the named beneficiary for the entirety of his or her life and the income stream will terminate at the beneficiary's death, with no residual benefit to any other beneficiary.

If the annuity contains a guarantee period (for example, 10 years), payments will be guaranteed to continue for at least 10 years or for the entirety of the life of the primary beneficiary, whichever is longer. In the event that the primary beneficiary dies prior to the expiry of the guarantee period, the balance of the guaranteed payments will be paid to the secondary beneficiary (usually as a lump sum, commuted amount).

Example: Manny left $500,000 to his wife, Sylvia, via his life insurance policy, when he died. Wanting to ensure that she would have an income for life from the insurance proceeds, he pre-selected a settlement option of a life income.

Life income settlement options are most appropriate where the policyowner does not feel that the beneficiary has the necessary skills to manage or invest the insurance proceeds herself, or himself, and wishes the beneficiary to receive a guaranteed income for life.

Parties to a life insurance contract

All life insurance contracts, like all legal contracts, must involve at least two parties: the insurer and the insured. But some life insurance contracts are third-party contracts: In addition to the insurer and the insured, the policy insures the life of someone (the life insured) who is not the insured under the contract.

The parties to a life insurance contract include:

Insurer: The insurer (that is, the life insurance company) under a life insurance contract is the person or organization that contracts to pay out the policy death benefit to the named beneficiary, in the event that the life insured should die while the policy is in force.

Insured: The insured is also called the policyowner. The insured takes out insurance on someone's life (usually himself or herself) to protect the insured or the insured's dependants against loss that would be incurred in the event of the death of the person whose life is insured (the life insured).

Normally, the insured is also the applicant under the life

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insurance policy. But because life insurance policies are transferable, the insured could end up being someone other than the original applicant. The insured/applicant must have an insurable interest in the life that is insured at the time of application: the insured or the insured's dependants must be at risk of financial loss in the event of the death of the life insured.

Life insured: The life insured is the person upon whose life the policy is based. It is the death of the life insured that triggers the payout of the death benefit. The life insured may also be the insured or may be a third party (such as a child of the insured). Legally, the life insured (if he or she is not also the insured) is not actually a party to the insurance contract.

Beneficiary: The beneficiary is the individual to whom the death benefit is paid. The beneficiary could be a person, an organization or the estate of the policyowner (the insured). The beneficiary is normally identified by the applicant (the insured) on the application for insurance, although the beneficiary could be changed.

If no beneficiary is named in the policy or if the named beneficiary has died and no replacement is named, the policy proceeds will be paid to the insured (or the insured's estate if the insured was also the life insured under the policy).

Technically, the beneficiary is not actually a legal party to the insurance contract. He or she has no legal rights or obligations under the contract, other than the right to receive the death benefit.

Example: Gertrude, married to Werner, provides a free babysitting service, every day, for her working daughter. The daughter doesn't know what she would do if she didn't have her mother's help. She couldn't afford to pay a babysitter herself and neither could her parents. To provide for the cost of babysitting, should his wife die, Werner (the insured) applied for a term life insurance policy with the Acme Life Insurance Company (the insurer) on the life of Gertrude (the life insured), with their daughter (the beneficiary) named to receive the death benefit.

Beneficiaries

DESIGNATION OF A BENEFICIARY

An applicant for insurance designates a beneficiary in the application form. Under insurance law, a policyowner can change a beneficiary at any time unless the beneficiary has been designated "irrevocable," in which case the beneficiary must consent to any changes. The applicant or the policyowner can also designate his or her own estate as beneficiary, rather than a person.

Any changes in beneficiary designation should be made by declaration in writing to the insurer. Most insurers supply appropriate forms for beneficiary changes.

If the estate has been designated to receive the death benefit from an insurance policy, a policy owner can direct the subsequent disposition of an amount equal to the insurance proceeds through a legacy in his or her will. The policyowner's will should specify the insurer, policy number and the specifics of the disposition of the insurance proceeds.

It is also possible, by will, to change the designation of a person named as beneficiary of a life insurance policy, by designating another person in the will. In order to do this, the clause must specify the insurer, policy number and the new beneficiary(ies). Whichever is the latest beneficiary designation will prevail in law. Nevertheless, the insurance company is empowered to make payment to the beneficiary named on their records, and any subsequently named beneficiary or beneficiaries would have to take legal action against the recipient of the insurance proceeds to recover their rightful inheritance. If this right of the insurance company to pay proceeds to the named beneficiary with impunity were not the case, the need for insurance companies to verify that their designation is the last and binding designation would hopelessly delay the claims process.

The disposition of insurance proceeds by will, through one's estate, may result in additional costs (for example, probate fees) and delays, but may be appropriate in some situations. For instance, the policy proceeds may be required to provide estate liquidity to pay estate expenses or cash bequests or may be intended to be held in trust on behalf of a beneficiary.

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BENEFICIARIES PRIOR TO JULY 1, 1962

Up to and including June 30, 1962, there were four classifications of

beneficiary:

1. Beneficiary for value.
2. Preferred beneficiary.
3. Ordinary beneficiary (any named individual other than in (1) or (2)).
4. Estate.

Preferred beneficiaries are the husband, wife, children, adopted children, grandchildren, children of adopted children, father, mother and adopting parents of the person whose life is insured.

Under the law prior to July 1, 1962, a designation by the insured of a member of the preferred class of beneficiaries created a trust in favour of that beneficiary and the insured was restricted in dealing with the policy. Once the insured had appointed a member of the preferred class as beneficiary, no change could be made in favour of a beneficiary outside that class without the preferred beneficiary's consent. Also, the insured could not obtain a loan or the cash surrender value or assign the policy without the preferred beneficiary's consent.

Over time, it became apparent that the trust concept in favour of preferred beneficiaries actually worked a hardship in some cases and led to various devices by those insured to circumvent the trust. Therefore, the revision in the law that took place July 1, 1962, was designed to retain protection against creditors but to eliminate the trust concept.

On July 1, 1962, all previous designations in classifications (3) and (4) became automatically governed by the new Act in every respect. However, any beneficiaries in the categories (1) and (2) on June 30, 1962, still retain their existing rights as beneficiaries. These rights will continue to be governed by the previous law respecting beneficiaries unless, and until, such beneficiaries cease to be preferred beneficiaries, or beneficiaries for value, in accordance with the provisions of the previous law.

Example: Assume that a policyowner named his wife as beneficiary prior to July 1, 1962. This automatically created a trust in favour of the wife as a preferred beneficiary and the policyowner cannot deal with the policy without his wife's consent, except that he can change the beneficiary to someone else in the preferred class. However, the wife can release her interest, which would automatically invoke the provisions of the Act. The policyowner could then reappoint his wife as a revocable beneficiary, for example.

Under the new act, the policy would still retain its protection against the policyowner's creditors so long as it remains payable to anyone in the protected class, which now includes spouse, child, grandchild or parent, but the policyowner can change the beneficiary or deal with the policy at any time (for example, to obtain a loan) without the beneficiary's consent. (See the section protection against creditors, below.)

BENEFICIARIES ON OR AFTER JULY 1, 1962

Since July 1, 1962, there are three types of designation in the common-law provinces:

- **Irrevocable beneficiary:** This is an unalterable designation of any person, the insured having relinquished the right to change the beneficiary. The word "irrevocable" must be used in the designation. The beneficiary, however, is empowered to give written consent to a change in the designation assuming they are at the age of majority.
- **Revocable beneficiary:** This is any person designated as a beneficiary, but not irrevocably. Such designation is subject to change at any time by the insured, without the consent of the beneficiary.
- **Insured or estate of the insured:** The insured and estate of the insured are not classified as beneficiaries under the law, but either (or both) can nevertheless be designated to receive the insurance proceeds. Such a designation is subject to change, at any time, by the insured.

The trust in favour of preferred beneficiaries has been replaced by this greatly simplified system of designating beneficiaries. The changed system retains the protection against creditors but eliminates most of the inflexibility of the old law, which caused hardship in some cases. Any person or organization (for example, a charity, foundation or company) can be designated as a beneficiary.

The insured may also appoint one or more than one

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contingent beneficiary to receive all or part of the insurance proceeds in the event the primary beneficiary is not living at the time the policy matures. If no beneficiary is designated or if no designated beneficiary is alive at the life insured's death, the policy proceeds are payable to the insured (owner of the policy) or his or her personal representative.

Irrevocable beneficiary

If the insured designates an irrevocable beneficiary, the contract is placed beyond the owner's sole control. This means that the owner's normal rights under the contract may only be exercised with the beneficiary's written consent. Without such consent, the owner may not surrender the contract for cash or borrow on the cash value of the contract, may not assign the contract and may not appoint someone else as beneficiary.

The owner may designate any person irrevocably in the application or subsequently by a declaration filed with the insurance company. An irrevocable designation of a beneficiary, however, cannot be made in a will. This procedure eliminates the so-called "hidden" declaration where a preferred beneficiary before July 1, 1962, could be designated in a will that often was not filed with the insurance company until a claim was payable. It is the responsibility of the agent to explain fully the consequence of an irrevocable appointment before it is made.

Revocable beneficiary

In the case of policies governed by the law that went into effect on July 1, 1962, any designation of a person as beneficiary can be revoked or changed unless the designation was specifically stated to be irrevocable. Accordingly, a beneficiary named by a simple designation may be described as a revocable beneficiary. The designation of the beneficiary or of the estate may be made in the application or in a separate declaration at any time.

Any designation of a revocable beneficiary may be changed by the insured at any time without the consent of the beneficiary. Furthermore, the insured may deal with the policy in any way including surrender, loan or assignment without such consent. The insured has the right to appoint a trustee for the beneficiary and payment of the insurance money to the trustee will discharge the insurer from any further liability.

PROTECTION AGAINST CREDITORS

Irrevocable beneficiary

When the insured designates a beneficiary irrevocably, the insurance money is not subject to the control of the insured or of the insured's creditors and does not form part of his or her estate for probate purposes. An irrevocable designation of beneficiary excludes creditors of the insured from the time of the beneficiary designation. As any person can be designated irrevocably, this protection provides a wider exclusion of creditors than was possible under the act prior to July 1, 1962. To this extent, protection continues to apply to preferred beneficiaries designated under the terms of the previous act.

A similar protection against the insured's creditors may apply if the designation of beneficiary is not irrevocable, but is in favour of a spouse, child, grandchild or parent of the person whose life is insured. This protection against creditors (where these specially protected persons are designated) retains, for the most part, the protection that existed in favour of the class of beneficiaries known as "preferred" under the previous act. In some jurisdictions, common-law partners may also qualify as preferred beneficiaries, but the rules vary in terms of who may or may not be considered a common-law partner.

Revocable beneficiary

In the case of a beneficiary designation that is revocable (and which is not in favour of any of the persons mentioned in the previous paragraph), there is no protection against the insured's creditors while the policy is in force. However, as soon as the insurance money becomes payable, it becomes an asset of the beneficiary and, therefore, is not subject to the claims of the insured's creditors. There is no protection against creditors at any time when the policy is payable to the estate of the insured.

Policy proceeds in the hands of the insurer are protected against the creditors, both of the insured and of the beneficiary, where they are payable in non-commutable instalments to the beneficiary. This means that the beneficiary must receive the proceeds by instalments and does not have the right to elect a lump sum payment.

CHANGE IN OWNERSHIP

Where an irrevocable beneficiary is not named under a life insurance policy, the owner (the insured) is free to deal with the policy and exercise all contractual rights, including the right to assign the policy collaterally or absolutely to a third party, without the beneficiary's consent.

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It is generally held that, upon the absolute assignment of the policy, the assignee shall automatically become the new beneficiary.

The owner also has the right to nominate a new beneficiary and/or a contingent owner, by agreement with the insurer.

OTHER CATEGORIES OF BENEFICIARY

Primary beneficiaries
The person named as the beneficiary to receive the death benefit proceeds of a life insurance policy is called the primary beneficiary.

If the primary beneficiary under the contract dies before the life insured dies and a new primary beneficiary is not named by the policyowner, then the policy proceeds will be paid to the contingent beneficiary, if any.

Contingent beneficiaries
A contingent (secondary, alternate) beneficiary may be named by the policyowner to receive the policy proceeds in the event that the primary beneficiary dies before the life insured and the insured has not named a replacement primary beneficiary.

Example: Sam took out a $500,000 life insurance policy on his own life, naming his wife, Doris, as the primary beneficiary. In the event that Doris should predecease him, Sam named his two adult children to be the contingent beneficiaries under the policy.

Of course, if Doris died, Sam could also elect to name a different primary beneficiary, to replace her under the contract.

If no beneficiary is named
If no primary beneficiary has been named or if the primary beneficiary dies before the life insured dies and no contingent beneficiary has been named, the policy proceeds would be paid to the insured (or the estate of the insured, if the insured was also the life insured).

Example: Abdul took out a policy on his daughter's life, naming his wife as beneficiary. Abdul's wife died in 2008 and Abdul never got around to changing the beneficiary on the policy. When Abdul's daughter died in early 2011, the policy proceeds were paid directly to Abdul, as the insured.

Policy assignments

A policyowner has the right to assign (transfer) his or her rights under the policy, in part or in full, to a third party. Assignments can be either absolute or collateral in nature.

ABSOLUTE ASSIGNMENT

An absolute assignment of a life insurance policy occurs when the current owner of the policy (the insured) transfers ownership of the policy outright to a third party (as contrasted with a collateral assignment, below). The transfer of ownership (the assignment) must, of course, be registered with the life insurance company that issued the policy.

The Uniform Life Insurance Act, subsection 200(3) provides that:

"Where a contract is assigned unconditionally and otherwise than as security, the assignee has all the rights and interests given to the insured by the contract and by this Part and shall be deemed to be the insured."

Thus the recipient of the policy becomes the insured and holds all the rights and powers of the insured with respect to the policy (the right to pay premiums, borrow against the policy, surrender the policy, change the dividend option (if applicable), convert the policy (if applicable) and exercise all options available under the contract.

The act is silent as to the result of the assignment of a policy with a revocable beneficiary, as to the status of that beneficiary after the assignment.

The general thinking is that the assignee now holds all rights and authority under the policy and therefore is entitled to all benefits under the policy, including the right to receive the policy proceeds. Thus, the assignee automatically becomes the beneficiary under the contract, without the necessity of actually completing a change of beneficiary form. The rights of the former beneficiary (named by the assignor) are expunged by the assignment. The new owner (the assignee) has the right to name a new beneficiary, other than himself/herself (or his/her estate), should he or she wish.

Example: Chuck took out a $25,000 whole life insurance policy on the life of his son, Bob, when

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Bob was born. When Bob turned age 21, Chuck transferred ownership of the policy to Bob by way of an absolute assignment. Bob paid all future premiums and had all rights of the policy (including becoming beneficiary of the policy) from that date forward.

The status of the former beneficiary is, however, not absolutely certain in law. Most U.S. jurisdictions, for example, have ruled that the beneficiary of an absolutely assigned policy is the assignee. Some, however, have taken the position that the former beneficiary (named by the assignor) has a vested right in the proceeds of the policy and that that right cannot be divested by the assignment.

COLLATERAL ASSIGNMENT

A collateral assignment transfers limited rights in the policy to a third party, usually for a limited period of time. Most typically, a collateral assignment is used to transfer an interest in the policy cash surrender value and its death benefit to a lender from the borrower (the policyowner), as collateral (security) for a loan.

Under a collateral assignment, the policyowner retains most of his or her usual rights under the contract (for example, the right to change the policy beneficiary) but cannot, without the permission of the collateral assignee, take any action that would impact the cash surrender value of the death benefit of the policy (for example, the policyowner cannot surrender the policy or withdraw funds from the policy).

A collateral assignment is usually only a temporary arrangement. The assignment would be discharged when, and if, the loan for which the policy was pledged as security is discharged.

Generally, the assignment will provide that any policy proceeds (cash surrender value or death benefits) must be paid jointly to the assignor (the borrower) and the assignee (the lender). The assignee will then release that portion of the proceeds that is not required to discharge any balance outstanding on the loan (plus interest, penalties, etc.).

Example: Mario assigned his $250,000 universal life policy to his bank as collateral for a $50,000 loan. The policy had a cash surrender value of $60,000 at the time of the assignment.

If Mario wished to surrender the policy, the cheque for the $60,000 cash surrender value proceeds would be made payable to Mario and the bank, jointly. Assuming no change in the value of the loan, the bank would keep $50,000 of the proceeds and release the other $10,000 to Mario.

If Mario were to default on his payments under the loan, the bank would have the right to withdraw $50,000 from the policy (to discharge the balance of the loan) and would then turn the policy (with a, now, net cash surrender value of only $10,000) back over to Mario. If the cash surrender value of the loan were not sufficient to cover the entire balance of the loan at the time of default, the bank would most likely simply surrender the policy and keep the entire cash value proceeds.

If Mario died, the insurance company would be required to pay the death benefit cheque to the bank and Mario's beneficiary, jointly. The bank would retain a portion of the death benefit sufficient to discharge the loan, $50,000 in this case, and turn the balance of the death benefit ($200,000) over to the policy beneficiary.

In order for a collateral assignment to be effective in protecting the interests of the assignee, the assignment must be registered with the life insurance company. Otherwise, the risk arises that, in the event of a death claim, for example, the insurance company would simply pay the policy proceeds to the beneficiary named under the policy, bypassing the assignee completely.

Issue around policies issued prior to Dec. 2, 1982

Policies last acquired prior to Dec. 2, 1982, ("prebudget policies") should not be disturbed (surrendered, converted, transferred to another owner, etc.) without consideration given to three important advantages that they possess (over policies last acquired after Dec. 1, 1982):

1. THE EXEMPTION TEST

Policies last acquired after Dec. 2, 1982, are subject to the exemption test to determine whether income earned within the contract can grow on a tax-exempt basis and are restricted as to the amount of cash value that they can accumulate on a tax-deferred basis.

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Policies last acquired prior to Dec, 2, 1982, are not subject to the exemption test and, therefore, can accumulate a higher amount of cash value on a tax-exempt (deferred) basis. This makes the prebudget policies more valuable as a "tax-sheltering" vehicle.

2. THE ADJUSTED COST BASIS (ACB) CALCULATION

For policies last acquired prior to December 2, 1982, the basic formula for computing the adjusted cost basis of the policy is:

> Aggregate Premiums paid – Aggregate Dividends paid out = Adjusted Cost Basis

In the case of life insurance policies last acquired after December 1, 1982, the adjusted cost basis of the policy is reduced by the net cost of pure insurance (NCPI) calculation each year. The NCPI calculation is an adjustment made to take into consideration the effective term cost of the insurance protection provided to the insured each year.

Thus, the basic formula for the adjusted cost basis of a policy last acquired after Dec. 1, 1982, is:

> Aggregate Premiums paid – Aggregate Dividends paid out – NCPI = Adjusted Cost Basis

The reduction for the NCPI results in a lower adjusted cost basis for policies last acquired after December 1, 1982. The formula for computing the taxable gain from the surrender (or otherwise disposition) of a life insurance policy is:

> Cash Surrender Value – Adjusted Cost Basis = Policy Gain

The smaller the ACB, the greater the taxable gain. Thus, in the case of two otherwise identical policies, upon surrender, one issued after December 1, 1982, would result in a tax reporting of a larger gain than one issued prior to December 2, 1982.

3. ANNUITIZATION

All cash value life insurance policies have a provision guaranteeing the policyowner the right to convert the net cash surrender value of the policy to an annuity, usually with a minimum guaranteed monthly income per $1,000 of cash value.

In the case of life insurance contracts last acquired after December 1, 1982, annuitization constitutes a disposition of the contract, for income tax purposes, with attendant reporting of any gain in the contract in the year of annuitization. The full net cash surrender value of the life insurance contract then becomes both the single premium paid under the annuity and the adjusted cost basis of the annuity.

Example: David owned a life insurance contract, issued in 1990, with a cash surrender value of $32,000 and an adjusted cost basis of $22,000. If he were to annuitize the policy in 2011, David would have to report the $10,000 policy gain ($32,000 - $22,000) as income for 2011. Assuming that David annuitized the entire cash value of the policy, the ACB of the annuity would then become $32,000.

In the case of policies issued prior to Dec. 2, 1982, annuitization of the cash surrender value of the policy does not constitute a disposition of the policy for income tax purposes. The ACB of the life insurance policy becomes the ACB of the annuity.

Example: If David's life insurance policy had been issued in 1980 (instead of 1990), annuitizing the cash surrender value of the policy in 2011 would not constitute a disposition of the policy and there would be no policy gain to report in that year. Although the full $32,000 cash surrender value of the life insurance policy would be used as the single premium for the annuity, the ACB of the annuity would be only $22,000 – the same as the ACB of the life insurance policy. The $10,000 policy gain would be reported, not entirely in 2011, but in subsequent years, pro rata, as it is distributed to David via the annuity.

The advantage, then, of prebudget policies is that tax reporting of the gain in the policy can be deferred (in part) upon annuitization, over the life of the annuity.

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Section summary

You should now be able to:

- Explain the impact of policy provisions, including:
  - Entire contract.
  - The right of rescission.
  - Suicide clause and incontestability clause.
  - Material misrepresentation.
  - Grace period.
  - Reinstatement.
  - Misstatement of age or sex.
  - Smoking status.
  - Settlement options.
- Identify and explain the features of a preferred beneficiary clause.
- Recognize that there are issues to address and that assistance may be needed with a policy issued prior to 1962.
- Explain the difference between a revocable beneficiary and an irrevocable beneficiary.
- Explain the difference between primary and contingent beneficiaries.
- Explain the consequences of an absolute assignment.

5:4 TERM INSURANCE

The most basic form of life insurance is term insurance. Indeed, originally, the only form of insurance available was term: a policy that provided protection for a term of one year only.

Essentially, term insurance is life insurance stripped to its most basic components: premiums and protection. The policy may have provisions that vary the amount of death benefit, permit the term of the coverage to be extended or permit the policy to be converted into a permanent form of coverage. The base policy itself is all about protection: most term policies offer no cash surrender value or ancillary benefits.

Example: Anna, aged 35, is the sole shareholder and president of Luxury Lamps Inc., which produces custom table lamps. After presenting her business development plan to the local bank, she was given a loan of $100,000, to be repaid in full in five years. While her business is incorporated, the bank insisted that Anna take out life insurance to repay the loan in the event of her death.

After considering alternative forms of life insurance, she has applied for a five-year term insurance policy for $100,000. Her company is the owner and beneficiary of the policy and she has registered a collateral assignment with the life insurance company in favour of the bank.

Should Anna die during the five-year term of the policy, the proceeds will be applied to repay the outstanding balance of the loan and any extra money will be paid to the company. At the end of the five-year term, the loan will be repaid and Anna can discontinue the coverage.

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If her policy included provisions to renew the policy, her company could continue to maintain the policy at a premium based on her age and use the insurance for a different purpose. For example, the company could continue as beneficiary and any insurance proceeds could be used to address short-term financial needs in the event of Anna's death.

If the policy contained a conversion provision, the company could convert the policy to a permanent life insurance plan to address longer-term financial needs.

The term insurance policy provides a specific amount of life insurance for a certain period of time. The added options allowing for renewal or conversion offer the policyowner flexibility in continuing the insurance to provide for other purposes, even if the life insured's health deteriorates and she becomes uninsurable.

Components of a term life insurance contract

All term life insurance policies (all life insurance policies, actually) have the following basic components in common:

- **Initial face amount:** The initial face amount of coverage is the contractual amount of death benefit (for example, $250,000) that the insurer promises to pay to the policy beneficiary in the event that the life insured should die while the policy is in force.
- **Term of coverage:** The term of the policy is the period of time during which the policy is guaranteed to remain in force, provided the insured pays the policy premiums when they are due. In extreme cases, the term of a life insurance contract could be as short as a few hours (in the case of flight insurance, for example). Traditionally, term life insurance policies are issued for periods of one, five, 10 or 20 years or until the life insured's age 65. The term of the policy may be extended at the option of the insured.
- **Premiums:** The premiums paid by the insured to the insurer are the consideration paid under a contract of life insurance. If the premiums are not paid when they are due, there is no consideration and, therefore, no valid contract. Failure of the insured to pay premiums may result in the lapse (cancellation) of the policy and all benefits provided under the policy.

Example: Mort owns a term life insurance contract on his own life, with his wife named as beneficiary, on which the premiums are payable annually, on the first of January. In 2011, when Mort received his premium notice in early December, he set it aside to be paid at a later date. With all the year-end holiday confusion, Mort completely forgot to pay his insurance premium and the policy lapsed. In February, when Mort received his holiday credit card bills, he had a massive heart attack and died. Regrettably, Mort's wife received no payout under Mort's life insurance policy because the policy had lapsed (terminated) for want of consideration.

Premiums are a function of the face amount of insurance applied for, the term of the policy, the age and sex of the life insured, and health and lifestyle of the life insured. They are most often paid monthly or annually, although other options are available (quarterly, semi-annually, etc.).

Provincial premium taxes: Most provinces levy a premium tax on deposits (premiums) going into a life insurance policy. Typically, the premium tax is computed as 2% of the gross premium. Thus, for example, in the case of a term life insurance policy with a $1,000 annual premium, $20 goes to the provincial government and $980 is retained by the life insurance company.

Term death benefit options

Although you usually think about term insurance as offering one fixed amount of death benefit, there are three death benefit options typically available in the market (although not all life insurance companies offer all three options): level, increasing and decreasing.

LEVEL DEATH BENEFIT

By far, the majority of term life insurance policies issued offer a level death benefit for the duration of the contract. The face amount of death benefit (for example, $250,000) is established when the policy is applied for and remains fixed as long as the policy remains in force. If the life insured dies, the face amount of the death benefit is paid to the beneficiary named in the contract.

INCREASING DEATH BENEFIT

Some term life insurance policies offer a death benefit that increases periodically, on a pre-established schedule, usually annually or every five years. Either the death benefit increases by a preset dollar amount (for example,

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$10,000 a year) or by a preset percentage of the original face amount of coverage or the increases are tied to an external factor, such as annual increases in the consumer price index (CPI).

The total amount of coverage offered under increasing term policies is usually capped at either a specified dollar amount (for example, $500,000) or at a factor of the initial face amount of coverage under the contract (for example, two times the initial face amount).

The death benefit usually increases for a set period of time (for example, for five or 10 years) or until the death benefit cap is reached, whichever comes first.

Policy premiums normally increase, periodically, pro rata with the increase in death benefit.

Increasing death benefit policies are typically used to provide protection against a liability that is expected to increase, year over year.

Example: Terri, single, owns an RRSP with a fair market value of $120,000. She is no longer making contributions to the plan, but it is increasing in investment value by about 8% per annum. If she were to die today, Terri's estate would have to pay about $50,000 in tax on the deemed proceeds of the RRSP. Terri is leaving her RRSP to her brother (via her will) and wants her brother to receive the full value of the RRSP, not the after-tax value of only about $70,000 ($120,000 – $50,000).To ensure that the taxes on the RRSP will be paid, Terri takes out a term life insurance policy on her own life in the amount of $50,000. She only needs term insurance, because she expects to start drawing the RRSP value down, starting in about 10 years, and hopes to use up the full value of the RRSP before she dies.

In order to ensure that the taxes on the RRSP could be paid at her death, Terri chooses an increasing term life insurance policy with an 8% indexing factor. That way, the value of the life insurance death benefit should remain fairly consistent with the value of the tax liability associated with the RRSP.

DECREASING DEATH BENEFIT

In the past, decreasing death benefit term policies were fairly common. They were most often sold as coverage for a home mortgage. As the principal balance outstanding on the mortgage declined, over the years, so did the face amount of death benefit under the term policy. The duration of the life insurance policy was designed to match the term of the mortgage.

Usually, the premium under a decreasing term policy remains level for the life of the plan, even as the death benefit decreases. The premium charged for a decreasing term policy is less that the premium for a level term plan of the same duration, reflecting the fact that the insurer's exposure to risk will decline over the years as the death benefit payable under the policy decreases.

The need for decreasing term life insurance plans has decreased as term coverage has become less expensive and since people seldom lock themselves into long-term mortgages anymore.

Renewable and non-renewable term plans

As noted above, the "term" under a term insurance policy is typically fairly short, most often one, five or 10 years. This does not mean, however, that the policy itself necessarily terminates at the end of a given term. This depends on whether or not the policy is guaranteed to be renewable.

NON-RENEWABLE TERM PLANS

A non-renewable term policy is issued for the duration of the current term and then it terminates. For example, a non-renewable five-year term policy will provide coverage for five years, after which time the rights and obligation of both the insurer and the insured end. If the insured wishes to extend his or her coverage beyond the term period, a new policy will have to be applied for and underwritten on a stand-alone basis (not as an extension of the previous policy). Such policies might be appropriate to insure short-term debt, for example.

RENEWABLE TERM PLANS

In the case of renewable term policies, the policy is issued for a fixed period of time (for example, five years) but, at the end of that period, the insured has the guaranteed right (but not an obligation) to extend (renew) the policy for another like term (for example, another five years) without having to provide medical evidence of insurability.

Typically, the premium for the first term of the policy will be set at a fixed annual amount (for example, $240 a year for five years) and this amount will increase for the next

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term (for example, $320 a year for the next five years) should the insured elect to extend the life of the policy.

The premium level for each term is based on the life insured's attained age at the time of renewal and is usually guaranteed in advance, for the life of the policy.

A typical renewable term premium schedule might appear as follows:

Policy Term Premium	Life Insured's Attained Age at Renewal	Annual for the Term
Years 1 – 5	30	$240
Years 6 – 10	35	$275
Years 11 – 15	40	$340
Years 16 – 20	45	$390
Years 21 – 25	50	$475
Years 26 – 30	55	$630

Typically, the increase in premium, term over term, is relatively modest in the early policy years, while the life insured is still relatively young. However, as the life insured ages, the policy premium increases become much more significant and may, in fact, become unaffordable for older lives insured.

The right to renew the policy will normally have an end date (for example, age 65), such that the policy cannot be extended indefinitely.

RE-ENTRY TERM

Some insurers offer re-entry term policies. With these products, two options become available to the policyowner at the renewal date.

- If the life insured is in relatively good health, he or she may requalify medically and become eligible for a substantially reduced renewal premium, compared to the guaranteed renewal premium.
- If, on the other hand, the life insured's health has deteriorated, the policyowner is guaranteed the option to renew for a new term, but pays the regular, guaranteed renewal premium.

The regular renewal premium for this type of policy is somewhat higher than for policies without the re-entry provision, but initial premiums are usually lower. This is because the insurer is not required to make immediate provision for higher mortality, since those lives insured who become "bad risks" will be compelled to pay significantly higher premiums in the long run, if they choose to retain their contracts.

Convertible term plans

Lastly, some term insurance policies offer the policyowner the right to convert (change) the term policy to some form of permanent insurance, issued by the same insurance company, at a future date. The key to the conversion right is that the insured can complete the conversion without having to provide medical evidence of insurability. The insured can convert the policy regardless of his or her state of health at the time of conversion, even if he or she is no longer insurable.

The new policy issued under the conversion option is generally treated as an extension of the old contract, for income tax and contractual purposes. This could be important, for example, with regard to the application of the incontestability and suicide clauses under the two contracts.

Example: Bo purchased a term insurance contract from the Acme Life Insurance Co. in 2005.The policy contained a standard provision that the death benefit would not be payable if the life insured committed suicide within two years of the issue date of the policy.

In 2010, Bo converted his term policy to whole life insurance, under the conversion clause contained in the term policy.

In 2011, despondent over the bankruptcy of his business, Bo committed suicide. Fortunately for Bo's beneficiary under the policy, the new whole life insurance contract was treated as an extension of the original term policy, under the terms of the conversion option. The standard two-year suicide clause contained in the whole life policy applied, because the suicide exclusion period that was applicable started with the issue of the term policy back in 2005. By the time of Bo's death in 2011, the suicide clause had long since expired.

The premium payable under the new (converted) policy issued under a conversion option will be based on the premium schedule for the new (not the old) policy, but could be based either on the life insured's original age

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(when the original term policy was issued) or his or her attained age at the time of conversion.

Term conversions can lead to anti-selection against the life insurance company, as those lives insured who wish to convert are most likely to be people who could not qualify for coverage (or at least could not qualify at standard rates) anywhere else. To help counteract this tendency, insurers charge higher premiums for convertible policies than for policies that are not convertible. As well, the conversion option usually terminates at the life insured's age 55 or so.

ATTAINED AGE CONVERSION

If the conversion option under the term policy provides for an attained age conversion, the premium for the new policy is based on the life insured's current attained age at the time of conversion and the premium schedule for the new policy.

Example: Jarri purchased a five-year renewable term policy in 2007, when he was 40 years old, thinking that he only needed term because the insurance was intended to cover a fairly short-term business debt. The good news for Jarri is that the business venture that he had borrowed the money to undertake ended up being a huge success and the value of his business interest increased significantly. The bad news was that Jarri now had a long-term capital gains tax exposure and needed to convert his term plan to permanent insurance. Jarri's term policy stated that conversions were to be affected at attained age. When Jarri converted the term policy to whole life coverage in 2011, the premium for the new plan was based on his then-current age of 44.

ORIGINAL AGE CONVERSION

If the conversion option under the term policy provides for an original age conversion, the premium for the new policy is based on the life insured's attained age at the time the original term policy was issued, irrespective of his or her age at the time of conversion, and the premium schedule for the new policy. Thus, the premium for the new, permanent plan under an original age conversion would be lower than if the same conversion had been done on an attained age basis.

Example: If Jarri had owned a term policy with an original age conversion clause, the premium for the whole life policy that he acquired in 2011 would have been based on his age 40 when he purchased the term plan back in 2007.As a consequence, he would have paid a significantly lower premium for the whole life policy that he paid under the attained age conversion.

There is one major disadvantage to original age conversions. The newly issued permanent plan issued via the conversion will have cash values computed as though it had been issued on the issue date of the original term policy. In order to compensate the insurance company for the retroactive adjustment of values under the new permanent plan, the policyowner would be required to make a (possibly substantial) lump-sum payment to the insurer, at time of conversion.

In pricing the term insurance policy, insurers will build in a higher premium for original age conversion than for attained age conversion, because the insurer runs the risk of being paid a lower premium (based on the insured's younger original age) for the life of the new whole life policy, in the event that the conversion option is exercised.

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LIFE INSURANCE PRODUCTS

Advantages, disadvantages and limitations of term insurance

Although the majority of all life insurance policies sold are term plans, they are not the answer to every insurance need. The following chart highlights some of the advantages and disadvantages of term policies:

Characteristic	Advantages	Disadvantages
Premiums	Low initially. The policy is easier to initiate and easier to maintain while the life insured is still relatively young (under age 50).	Premiums escalate, dramatically for 5 to 10 YRT, often becoming unaffordable when the life insured reaches age 60 or so.
Duration	Short - usually not beyond age 75. Keeps initial premium costs low, because the insurer does not have to pay out a death benefit in the vast majority of cases.	Short - usually not beyond age 75. Most lives insured live beyond the expiry date of the contract; so no death benefit is ever paid.
Flexibility		None. Usually, no features of the plan can be changed once the policy has been issued.
Adaptability		None. If the premium isn't paid when due, policy will lapse within 31 days and coverage is lost.
Tax Leverage		No cash values, so it is not possible for the policyowner to utilize the tax-deferred investment environment within an exempt life insurance contract.
Administrative Component (i.e., the policy fee)		High, relative to the premium costs of the term policy.
Longevity		Short. Very few terms policies are kept in force beyond five years after they are issued.

TERM TO 100

To attain the sort of permanence available with whole life policies, some insurers issue term to age 100 policies. The premiums for these contracts are usually level for the life of the policy (that is, to the life insured's age 100). Term to 100 does not usually build up any cash surrender value, has no loan value, is not participating and does not pay dividends. Term to 100 plans do not usually have any cash surrender values but some contracts offer a refund of premium option – in the event of surrender of the contract after a number of years (usually 20) – or a reduced paid-up value – in the event that premium payments are stopped by the policyowner after a number of years. Some plans, the exceptions, do have a cash value, although the amount of cash value is less than a comparable whole life policy.

Because claims for these contracts are potentially greater than claims for all other types of term insurance, premiums paid in the early years are significantly higher than for other types of term policies. In the long term, premiums for a term to 100 policy taken out at a young age will likely be much lower than the attained age premiums charged to policyowners in their 50s or 60s under renewable term plans. Of course, term insurance with shorter periods will have even lower initial annual premium costs.

When to recommend term insurance

Term insurance has two characteristics that make it the ideal life insurance product in many circumstances:

- It can be made available at comparatively affordable premium rates because the term plan is not a commitment from the insurance company to cover the life insured for the whole of life. (Most term policies expire by the life insured's age 75 at the latest and the death benefit never has to be paid.)
- They are ideal products to protect short-term liabilities because, in the early policy years, five- and 10-year renewable term plans are inexpensive. The policyowner does not need long-term benefits, so can use term policies to solve his or her liability problem, avoiding the need to build up the large policy cash values and reserves required

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for permanent life insurance solutions.

THREE CASE STUDIES

When is term insurance an appropriate product recommendation, what term insurance is appropriate and why?

Example 1: Charles, who lives in an apartment, just bought a cottage with a $50,000 mortgage that will be paid in 10 years. He doesn't have any other debts of any significance yet but expects to buy a house once his cottage is paid for.

Charles, 27, is in good health but the men in his family have a tendency to develop high blood pressure in their 40s.

Between the rent on his apartment and mortgage payments on the cottage, Charles is a bit strapped for cash. He wants to life insure his mortgage and asks his agent for a recommendation.

Solution: Charles' agent recommended a $50,000 10-year renewable and convertible term policy.

Rationale: Charles only needs the coverage for 10 years, as of now, so the term would be appropriate, and the use of short-term term insurance will keep Charles's premium costs low.

Since Charles is likely to need further coverage after the cottage mortgage is paid off (to cover a mortgage on his house) and may not be insurable (or insurable at standard rates) when the time comes, the agent recommended a policy that was both renewable and convertible to keep Charles's options open.

Example 2: Marjorie just took out a one-year bank loan for $100,000 to get a new business venture started. Most of the loan proceeds will be invested in inventory and Marjorie will easily be in a position to discharge the loan by, or before, its term ends. The bank insists that Marjorie protect its position by life insuring the full loan. Marjorie is very cost-conscious and, given that the loan will be of short duration, wants to resolve the issue as inexpensively as possible.

Solution: If Marjorie can be certain she will not need the coverage after the end of the first year, she should consider one-year non-renewable-non-convertible term coverage.

Rationale: It would offer her the protection that she requires at the lowest possible price.

Example 3: Henri, 40, has just purchased a new home in a wealthy area of his city, with a $200,000 mortgage. Henri likes guarantees, so he opted for the bank's new 25-year mortgage, offering a guaranteed interest rate from now until his mortgage is paid off and he retires, at age 65.

Henri is single, so he doesn't need to worry about protecting a spouse, but he would like to see his house pass to his favourite niece and her husband when he dies. If he is going to leave the young couple a gift, he would like it to be a full gift, so he would like to life insure his mortgage so that he could pass the home to them debt-free.

Solution: Henri's agent recommended a level, term-to-65 policy, in the amount of $200,000.

Rationale: The policy premiums will remain level, just like Henri's mortgage payments, until the mortgage is paid off. Then there will be no future need for the coverage so permanent insurance is not an issue. If Henri wants to "hedge his bets" on future coverage, he could add a convertibility feature to the policy, allowing him to convert the policy to permanent coverage by age 55.

The agent did not recommend decreasing term; the premium difference between the two contracts was too small to be worth the reduction in the coverage – Henri could use the excess coverage (over and above the mortgage balance) for estate liquidity.

Tips on matching term policies to client's needs

A number of factors need to be taken into consideration when you make recommendations to a client as to which type of term policy (if term insurance is indicated) should be applied for:

DEATH BENEFIT

In most cases, a level death benefit is called for. However, sometimes the death benefit will need to increase – in the case of a growing liability, like capital gains taxes on a

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growth asset, for example – or decrease – like insurance intended solely to cover the balance of a mortgage or protect a growing education fund.

If there is a chance that the insurance coverage may be required for some other purpose in the future, such as final expenses or taxes on the growth in value of a cottage, and may be converted to permanent coverage, then a level death benefit should generally be selected in place of a decreasing death benefit plan.

SINGLE OR JOINT LIFE COVERAGE

Most insurance policies are issued on a single life basis, but if the need to be covered could be triggered as the result of the death of one party or another (but not both), such as a mortgage or buy-sell agreement, then a joint first-to-die policy may be called for.

Similarly, if the need is only likely to be triggered at the death of the last to die of two or more people, such as tax on capital gains on property owned by a married couple, then a joint last-to-die policy may be called for.

GUARANTEED RENEWABLE

It is seldom appropriate to recommend that a client purchase a term insurance policy that is not guaranteed renewable. Even if the liability being covered is virtually guaranteed to be eliminated prior to the end of the term (like a four-year loan insured by a five-year term policy), situations may change. Other liabilities may arise to replace the one originally being insured against; or the life insured's health might change and he or she could become uninsurable. The cost of guaranteed renewability is relatively minor when weighed against the long-term risk of not being able to purchase replacement insurance for an expiring term policy.

CONVERTIBLE

Term insurance is best recommended to provide protection against the cost of a temporary liability (such as a bank loan or a mortgage) in the event of the death of the life insured. However, in many instances where permanent coverage is called for, the client cannot currently afford the premium cost of a permanent plan. In such circumstances, it is more practical to purchase affordable term coverage now (to protect against the liability) with the intent to replace the term policy with a permanent plan when affordability is not an issue. To guarantee the future purchase of permanent coverage, of course, the term policy would need to be convertible.

Likewise, in circumstances where the client is likely to need permanent coverage in the future, it is prudent to purchase convertible term insurance to protect temporary needs today and guarantee the right to acquire permanent coverage, if needed.

TERM VERSUS NEED

The longer the term of a policy, the greater the premium required. Thus, a 10-year term policy will have a higher premium for the first five years than would a five-year term policy. So avoid recommending a policy with a term that would extend unnecessarily long beyond the expected date that the policy would be needed.

For example, if a mortgage is to be paid off in 12 years, it would probably be best to insure it using five-year rather than 10-year renewable terms. The total premiums paid should be roughly the same for the first 10 years under either policy. But the premiums payable for years 11 and 12 should be much lower under five-year term than under a 10-year policy. No sense in the client paying more premium than is necessary and, if both contracts are renewable or convertible, both contracts would keep the client's future options open.

SUMMARY

It may be that on occasion some of these objectives are conflicting, such as the desire for as many options as possible and the ability to pay premiums. In those cases, it's the agent's task, working with the client, to prioritize objectives and design a program that best meets the client's primary priorities.

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Section summary

You should now be able to:

- Explain how term life insurance works.
- Explain the primary advantages/disadvantages and limitations of term life insurance for the policyholder.
- Differentiate among level term, increasing term and decreasing term life insurance.
- Differentiate between renewable and non-renewable term insurance.
- Explain the term "convertible term insurance."
- Select the most appropriate term individual life insurance product to meet specific needs.

5:5 PERMANENT LIFE INSURANCE

The concept of "permanent" life insurance is to be able to provide protection for the entire life of a life insured rather than just for a limited period of time (for example, one year).

In most instances, permanent policies are designed with a premium payment pattern of a level amount for the lifetime of the policy. This eliminates the need to charge progressively higher premiums as the life insured ages, as is done with most forms of term insurance.

Term versus permanent policies

There are many differences between term insurance and permanent insurance.

PREMIUM PATTERNS

The basic principle of premium calculation is simple: The premium is the amount of money required on the basis of the assumed mortality experience, together with assumed investment earnings, to pay the benefits promised on death and to pay an appropriate share of the insurance company's operating expenses.

Since a traditional term policy only exists for a fixed term (a number of years or to a certain age of the insured), premiums for such a policy are only payable until the end of the policy's existence. Should the insured wish to continue insurance coverage, the policy may be renewed or a new policy taken out (if the insured is still in good health). However, because the life insured will now be older and thus more likely to die in the near term, the premium for the new coverage will be higher – sometimes considerably higher.

Premiums for both term and permanent policies may be paid annually, every six months, quarterly, monthly or in a single payment. In each case, the premium payable is appropriately adjusted for interest earnings that the insurance company forgoes on premiums paid more frequently than annually. An annual premium is paid at the beginning of the policy year and the insurance company is able to earn interest for a full year when it invests that premium. The insurance company will earn a smaller amount of interest on premiums paid more frequently simply because it does not have the entire premium for the whole year. The insurance company applies a "modal factor" to the annual premium to arrive at the mode premium. For example, rather than charging .50 of the annual premium for a semi-annual mode the insurance company may charge .52 of the annual premium to account for the portion of the interest income it has lost by accepting premiums on a more frequent than annual basis.

PREMIUM LEVELS

In the case of traditional term insurance, coverage is only in effect for a limited period and little or no "extra" premium need be collected in the early years to pay for claims in later years (as is necessary with permanent insurance). Accordingly, the premium for a 20-year term policy will be lower than the premium for a whole life

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policy issued at the same age. In the case of the whole life plan, the difference collected in the higher premium is set aside to become a "policy reserve" available, with interest, to pay for claims in later years. For permanent life insurance policies, the reserve offsets the amount or sum insured under the policy. The sum insured less the reserve represents the net amount at risk to the insurance company in the event that the life insured dies while the policy is in force.

Permanent life insurance can take different forms but all of the various types have the policy reserve system in common.

Types of permanent life insurance plans:

- **Whole life insurance:** Premiums are payable for the entire life of the policy. The policy ceases or matures when the death benefit is paid on the death of the life insured or in very rare cases when the life insured reaches age 100. At that point the policy reserve will have accumulated to equal the sum insured.
- **Limited premium payment whole life insurance:** Premiums are payable for a limited number of years, for example, 20 pay life insurance. The reserve increases until it accumulates to equal the sum insured at age 100.
- **Endowment life insurance:** Premiums are payable for some specific period of time, for example, to age 65 of the life insured. The policy endows or matures at that time and an amount equal to the sum insured is paid to the policyowner and the coverage will cease. The sum insured will be paid if the life insured dies before reaching age 65.

As no funds are usually collected in reserve for term policies, little or no cash value accumulates in a term policy.

However, if a policyowner decides to terminate a permanent policy, the insurance company is released from its future obligations under the contract and the company will return to the policyowner an equitable share of the accumulated policy reserve – known as the policy's cash surrender value (CSV).

Cash surrender values are guaranteed and stated in the policy, and generally increase from year to year in permanent insurance policies, eventually (say, by ages 95 to 100) approaching or even equaling the sum insured. In the case of policies where dividends are left to accumulate as paid-up additions, cash values could easily eventually exceed the initial face amount of the policy.

This chart illustrates typical cash surrender value accumulations (including dividends invested in paid-up additions) within a whole life participating insurance policy.

Policy Year	Age	Annual Required Premium	Total Cash Surrender Value
1	41	$2,629	$314
5	45	$2,629	$2,137
10	50	$2,629	$25,475
15	55	$2,629	$57,037
20	60	$2,629	$105,798
25	65	$2,629	$182,723
30	70	$2,629	$297,997
35	75	$2,629	$464,848
40	80	$2,629	$701,426
45	85	$2,629	$1,032,079
50	90	$2,629	$1,493,954

Whole life Participating insurance with dividends invested in paid-up additions. Male, non-smoker, age 40, $100,000 initial face amount of insurance.

LOAN AND NON-FORFEITURE VALUES

Many years ago, a policyowner who held a permanent life insurance contract and who discontinued premium payments might forfeit all rights under the policy and receive nothing, regardless of how long premiums had been paid. Today, however, the owner of a permanent insurance policy has a number of guaranteed rights to the values in the insurance policy.

For example, the cash surrender value (CSV) of a permanent insurance policy, or at least a high percentage of it, is available to the policyowner as a loan during the lifetime of the policy. Most cash value policies also contain the automatic premium loan (APL) provision, which provides that unpaid premiums will be charged as a loan against the cash surrender value of the policy, thus avoiding inadvertent loss or forfeiture of the policy through non-payment by error or during difficult financial periods. As they become due, future premiums may also be charged as APLs until their total, with interest, equals the CSV, at which time the policy terminates.

A further non-forfeiture value, known as extended term insurance, is the right to use the CSV to keep insurance in force for a limited period after ceasing to pay premiums. The policyowner, in effect, cancels his or her permanent life insurance policy and uses the CSV to buy

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term insurance for the full sum insured for the number of years and days the CSV will purchase as a single premium at the life insured's attained age.

Another non-forfeiture value in policies with CSV is the right to reduce the policy to an amount of insurance that can be purchased as a single premium policy at the life insured's attained age. The reduced paid-up insurance will be of the same type as the original policy and will normally contain cash values. However, no further premiums are payable. Non-forfeiture options are discussed in more detail later in this Unit.

TAXATION - new rules for exemption test for policies issued after 2016

While life insurance proceeds paid on death have always been received free of income tax in Canada, the accumulation of substantial values in permanent insurance policies has led the federal government to ensure that life insurance does not receive preferential income tax treatment versus alternative forms of investment.

Currently, policyowners must periodically report the income accruing within a life insurance policy, except for policies that satisfy an annual "exemption test" applied by the insurer. In simple terms, a policy that is exempt from this reporting is one for which its cash values do not exceed the cash values that would accumulate in a notional endowment policy, issued at the same age and amount of insurance with premiums paid for 20 years and maturing at age 85 for its face amount. In other words, policies that accumulate relatively large cash values are considered by the government to be somewhat more like investments than insurance policies and thus face more stringent tax reporting rules.

For policies issued after 2016 the exemption test policy will be an 8-pay endowment at age 90. Being an endowment-type product, the ETP will have an accumulating fund at maturity equal to the benefit on death under the policy.

The accumulating fund of the ETP uses the Canadian Institute of Actuaries 1986–1992 mortality tables and an interest rate of 3.5 percent. This is designed to better reflect mortality rates and investment returns while improving consistency between the measurement of the savings in an actual policy and the measurement of the savings in the ETP.

Policies that were "last acquired" prior to Dec. 2, 1982, are not subject to the new rules and are known as grandparented policies, unless they lose that status as a result of policy changes.

Exempt and grandparented policies are generally sheltered from income tax on the investment earnings contributing to the growth in policy cash values. Such tax-deferral can create significant accumulation within the policy to fund future mortality costs and may provide living benefits to the policyowner. In addition, some policies (universal life plans, for example) may be designed so that the tax-deferred growth is paid out tax- free (over and above the basic death benefit) in the event of the policyowner's death.

A policy gain arising from disposition of a life insurance contract is fully included in income and is taxed similarly to interest income (and is not treated as a capital gain).

Term insurance policies (except, in some instances, term to 100) do not have accumulating values in the policies and thus, with no growth in value, do not face tax or reporting problems.

LIFELONG PROTECTION AT A PREDICTABLE COST

The major advantage of the whole life (or straight life, or ordinary life) insurance policy is its rock-solid permanence. Unlike term insurance, which is often purchased for a limited period only to lapse or expire before the life insured reaches an age of increased mortality, the whole life policy is designed to provide protection against financial losses associated with death, whenever that death occurs. A term policy is quite likely to have expired, or to have become extremely expensive, just when it is needed most.

A related aspect is the steady accumulation of values in the whole life policy – values that are often cherished by policyowners who come to see their insurance as an abiding and important asset, one not to be lightly squandered or endangered. Many small permanent insurance policies are carefully guarded by the elderly, who see in them a preservation of their dignity and an important degree of financial self-sufficiency for final expenses.

Finally, the whole life premium is often guaranteed not to increase (except in the case of variable or adjustable policies, see below) for life, while a term insurance policy usually must be renewed from time to time, or converted to a permanent plan, if insurance coverage is to be continued. When a term plan is renewed, the premium is based on the life insured's then-current age, thus causing premiums to increase sharply in later years.

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POLICY RESERVES AND NON-FORFEITURE BENEFITS

With whole life, the premium payments exceed those that would be required to pay for the pure risk of death in a year, plus expenses. Effectively, some of the insurance cost is prepaid or prefunded, giving rise to a policy reserve fund. (In later years, the annual mortality cost of policyholders will exceed the premiums and the shortfall will be withdrawn from this policy reserve.) Thus, a cash value builds up within a policy and this value gives rise to a number of valuable benefits for the policyowner.

For a whole life policy, the policy reserve offsets in part the "amount at risk" under the policy. The amount at risk is the insurer's liability to pay a death benefit. It is basically the death benefit less the reserve.

For a term insurance plan, the net amount at risk is always equal to the sum insured. For whole life insurance plans, the reserve increases to the point that it equals the sum insured.

During the lifetime of the policy, its cash value is available to be borrowed by the policyowner without delay, publicity or an approval process, ensuring peace of mind in emergencies, temporary assistance through a difficult financial period, or the opportunity to capitalize on an investment or business opportunity. Should a premium be forgotten or be difficult to pay, the cash value in the policy can be automatically borrowed to make the payment, avoiding the possibility of policy lapse. For those suffering from the financial and other stresses of a serious or final illness, this facility is important and extremely timely. Imagine the struggle to pay a term insurance premium, which one could not afford to miss, while experiencing a terminal illness.

Whole life policies now guarantee non-forfeiture values that protect the policyowner against loss should it become financially difficult to continue premium payments. Today, a policyowner who discontinues premiums on a whole life insurance policy (or most other permanent policies) may:

- Take the surrender value in cash, relinquishing the contract.
- Allow the automatic premium loan provision to function, using the policy's cash value as security.
- Use the cash value to purchase extended term insurance. That is, use the cash surrender value of the policy to buy term insurance for the full sum insured for the number of years and days that the CSV will purchase as a single premium.
- Use the cash value to purchase reduced paid-up insurance. That is, reduce the policy to an amount of insurance that can be purchased as a single premium policy at the life insured's attained age. The policy will be of the same policy type as the original policy, however it will be smaller, and no further premiums will be required.

For example, someone about to retire may wish to retain some lifelong insurance protection, but be concerned about being unable to pay the premiums out of a reduced retirement income. At retirement, for example, an existing whole life policy may be reduced and made paid-up, providing lifetime coverage at no further outlay.

FORCED SAVINGS

For those who do not have an organized savings program, or who do not have the investment interest or expertise to manage their funds well over quite long periods, life insurance policy values often turn out to be an important source of long-term savings. Also, as the funds accumulate gradually over time, relatively out of sight, they are somewhat less susceptible to being tapped for life's recurring emergencies and enticing luxuries.

On the other hand, those who purchase cheaper term insurance and have the discipline, cash and skill to invest the premium difference regularly over the long term, without significant losses along the way, can achieve superior investment returns, especially inside a tax-deferred RRSP. Of course, in an RRSP, you cannot withdraw premiums tax-free or borrow your cash. And, most of all, the policyowner has to actually make the regular investments and leave the money in the fund for many years.

TAX CONSIDERATIONS

If a person's wealth is tied up in real estate, stocks, art or a business, the Canada Revenue Agency (CRA) will want to collect taxes on his or her capital gains as soon as he or she dies. Instead of having these taxes paid from the estate, perhaps through a forced sale of assets at a loss, they can be paid with cash from life insurance proceeds. But that insurance must be in effect at the time of death (in other words, protection will be needed during the whole lifetime).

Whole life policies purchased before Dec. 2, 1982, (grandparented policies) are good tax shelters because they are treated as exempt from the tax reporting requirements that similar policies issued after that time are subject to.

ESTATE CREATION

If important assets are tied up in a business, farm or property that will be left to one heir, a significant and

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equal inheritance can be left to other heirs through using life insurance proceeds to dramatically increase the value of the estate. In such cases, the funds become available tax-free exactly when needed.

Using permanent insurance, arrangements can be made for the ongoing care of dependent children, parents or others, funded through life insurance proceeds that become payable when needed. That is, as long as the policyowner continues to maintain the permanent insurance plan, funds for care of dependants will be available should the life insured predecease their dependants.

Similarly, the life insured can make provision in his or her will for significant bequests to charities, schools, foundations, etc., funded with permanent life insurance.

DISADVANTAGES OF WHOLE LIFE INSURANCE

The major disadvantage of the whole life policy is the fact that "extra" premiums must be collected in the early policy years to fund the mortality in later years. In other words, this policy requires a higher premium outlay, initially, than does term insurance.

A further constraint is the fact that the insured is paying the same premium every year for declining protection, since the death benefit remains level, but an ever-greater proportion of that benefit is covered by the policy reserves that are not paid out on death in addition to the face amount of protection.

Example: Joe has an old policy that promises to pay $10,000 in the event of his death. The policy has, to date, accumulated a reserve (similar to a cash surrender value) of $4,000. If he dies now, $10,000 will be payable, even though Joe could have surrendered the policy for $4,000. In a few more years, the reserve might be $6,000, yet the same $10,000 of insurance is payable at death. The amount at risk by the insurance company reduces, yet the premiums remain the same.

Non-participating and participating policies

Life insurance policy pricing (the setting of premiums and values) is based on long-term assumptions regarding a number of factors, including:

- Mortality costs (claims payable under the policies that the insurer issues).
- Expenses (sales commissions, the cost of maintaining the policy on the books of the insurer, paying staff, etc.).
- Investment returns (on net premiums received).

Because most policies have fixed premiums and fixed cash surrender values, established at the time of issue, the insurance company can elect one of two methods for determining the values and allowing the policyowner to share (or not) in the performance achieved by the insurance company in the above-noted areas.

NON-PARTICIPATING (NON-PAR) POLICIES

In the case of non-participating policies, all values related to the policy (death benefits, cash surrender values, premiums) are determined at policy issue, for the life of the contract, and cannot be altered.

This means that the insurance company must assume all of the risk of future performance versus the actuaries' estimates. If the actuaries underestimated future claims or overestimated future revenues, the insurer is responsible for making up the difference: the policy values remain unchanged.

On the other hand, if the insurance company's actuaries underestimated future revenues or overestimated future claims, the excess profits that would result remain with the insurance company: the policy values remain unchanged.

From the perspective of the policyowner, there is a tradeoff of the prospect of future "profits" for the guarantee of future values.

PARTICIPATING (PAR) POLICIES

In the case of a participating policy, there is another factor, a variable, that comes into play in pricing the policy: dividends. If the actuaries are too conservative and the company makes excess profits, that excess is shared with the participating policyowners via the payment of annual policy dividends. The greater the success of the insurance company's performance, the higher the policy dividends. If the insurance company underperforms expectations, the dividends actually paid will be less than anticipated. In this way, the insurance company can share both the costs and the benefits of future performance with its policyowners.

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Generally speaking, the amount of the annual dividend payable under a participating policy will increase with the time that the policy is in force, so that the fifth year dividend would be greater than the dividend paid in the fourth year and so on.

Most term insurance policies are non-participating, while permanent plans (like whole life) may be issued as either a non-participating or a participating policy.

Dividend options

Dividends from life insurance may be used in a variety of ways:

- Paid to the policyholder annually in cash.
- Used to reduce the premium otherwise payable.
- Accumulated with interest as part of the policy.
- Used to purchase additional paid-up amounts of insurance (the most popular option).
- Used to purchase one-year term insurance for an amount equal to the policy's cash surrender value at the end of that policy year. This "fifth dividend option" is most useful in certain business life insurance situations where the death benefit is to be supplemented by reimbursement of the total premiums paid.
- Used to purchase a one-year term addition payable on the insured's death during that year.
- Used to purchase units in the insurer's segregated fund, oriented largely toward common stock.

Example: Charlie, aged 40, is the owner and life insured under a $100,000 whole life participating policy. He acquired the policy five years ago at an annual premium of $2,400. After five years, the policy is building cash value and Charlie is receiving annual dividends. This year's dividend is $700.

Considering the dividend options available, Charlie has the following choices:

- **Cash dividend:** He receives the dividend in cash and can spend or invest it any way he chooses.
- **Premium reduction:** Charlie will receive a premium notice for a net amount of $1,700 – his annual premium, less the current year dividend.
- **Interest accumulation:** The annual dividend is credited to a deposit fund to which the insurance credits interest. The dividends on deposit will continue to grow as annual dividends are added to the fund and interest is credited. Charlie will receive a tax reporting form for the interest he earns every year. He can withdraw some or the entire fund at any time. The fund balance will be paid to his beneficiary on his death. For example, the current annual dividend will be added to the deposit amount. Charlie's dividends on deposit have accumulated to almost $3,700.
- **Paid-up additions:** While this dividend option is in effect, the annual dividend will be applied as a single premium to acquire paid-up insurance of the same kind as the basic policy. Depending on the amount of dividend and the premium required to purchase the insurance, a small amount of insurance will be included as a paid-up addition to the policy. The total of paid-up additions will accumulate as dividends are declared each year and applied under this option. This year's dividend will provide a current amount of paid-up additions of $4,100 and his paid-up additions coverage is $20,000 with a cash value of $7,000.
- **The "fifth dividend option":** The annual dividend is applied to purchase one-year term insurance for an amount equal to the policy's guaranteed cash value at the next policy anniversary date. In Charlie's case, the $700 annual dividend will be applied to acquire one-year term insurance for an amount equal to the next anniversary's cash value of $3,500. If the required premium is less than the total dividend, the unused portion is applied under one of the other dividend options. This option might be used where there are policy loans and the benefit on death would be reduced by the amount of the loan.
- **One-year term additions:** With this option, the annual dividend is applied to acquire one-year term insurance for whatever amount the annual dividend will purchase. The amount of one-year term insurance will depend on the amount of dividend declared and the attained age premium for the term insurance benefit.
- **Segregated fund:** The dividend is applied as a contribution to a segregated fund. The dividend will purchase units in the fund depending on the unit value of the fund on the purchase.
- The policyowner may change the dividend option selected at any time, although a change to the additional term insurance option is subject to certain restrictions. A change to an option providing additional insurance may require an underwriting review and current evidence of insurability.

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NOTE: It is important to reiterate that dividends and any projections of dividend values are not guaranteed.

THE IMPACT OF DIVIDENDS ON DEATH BENEFITS

Many policyowners choose to use their dividends to purchase paid-up additions, enjoying the opportunity to purchase more insurance without providing further evidence of good health or new premium outlays. Also, the new insurance is provided without a charge to cover expenses.

Significant amounts of "extra" insurance can build up over the years on this basis – an important consideration in times of inflation or of declining health.

Another reason for the popularity of this option is that, while the dividends themselves are generally non-taxable (being refunds of premium), if they are left to accumulate with the insurer, any interest earned on them is subject to income tax but they remain non-taxable if invested in paid-up additions.

THE IMPACT OF DIVIDENDS ON CASH VALUES

Paid-up additions increase the total cash and loan values of the policy as well as the insurance values. They may be surrendered for cash or borrowed against without affecting the underlying policy. Also, paid-up additions themselves grow in value in the same ratio that a paid-up policy increases in value.

Of course, if dividends are left to accumulate, the total payable on the insured's death will be increased by the total of dividends and interest accumulated with the insurer. Similarly, if dividends were used to purchase segregated fund units, a benefit would be payable from that source.

Policy Year	Age	Annual Required Premium	Total Cash Surrender Value	Total Death Benefit
1	41	$2,629	$314	$102,218
5	45	$2,629	$2,137	$112,306
10	50	$2,629	$25,475	$144,025
15	55	$2,629	$57,037	$208,655
20	60	$2,629	$105,798	$299,994
25	65	$2,629	$182,723	$421,264
30	70	$2,629	$297,997	$580,738
35	75	$2,629	$464,848	$790,378
40	80	$2,629	$701,426	$1,066,175
45	85	$2,629	$1,032,079	$1,429,267
50	90	$2,629	$1,493,954	$1,907,228

Male, non-smoker, age 40, $100,000 initial face amount of insurance.

This chart illustrates the impact of the accumulation of paid-up additions on the total death benefit of a whole life participating policy.

THE COST OF INSURANCE

The purchaser of a non-participating policy has the advantage of guaranteed costs – along with the disadvantage of not reaping the benefit of favourable investment returns through dividends.

The holder of a participating policy pays a somewhat larger premium than the non-participating policyowner but receives substantial dividends over the years, reducing his or her net cost of insurance. In the past, over the long run, the owners of participating policies have come out ahead of their non-participating brethren. However, it remains true that the amount (or even the payment) of dividends is not guaranteed.

DIVIDEND ILLUSTRATIONS

The insurance company and the life insurance agent will provide illustrations based on the insurer's current dividend scale, but each such illustration must carry a clear statement that:

- The figures are based solely on the current dividend scale.
- The figures are neither estimates nor guarantees.
- Dividends of any size are not guaranteed.

It must be emphasized that any changes in the current

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dividend scale or in the rate of interest allowed on accumulated dividends will produce corresponding changes in the figures.

Unlike guaranteed cash values, which are, in fact, fully guaranteed, it must also be stressed that dividends actually paid in the future may be greater or less than those illustrated, depending on future experience. Many life insurance companies will prepare illustrations for clients at varying dividend rate assumptions, to further illustrate this point.

NON-FORFEITURE OPTIONS

Non-forfeiture options come into play when a policyowner cannot or does not pay the policy premiums when they are due and the 30-day grace period has expired.

In the case of a non-cash value term contract (such as five-year term), the only option available is for the life insurance company to cancel the contract and the policyowner will forfeit all future benefits and rights to which he or she would have been entitled under the contract.

However, if the policy has cash values or other values, the policyowner may select a non-forfeiture option to keep the policy, or at least some version of its benefits, in force.

Some non-forfeiture options are provided for automatically under the contract of insurance, such as the automatic loan provision. In such case, the automatic non-forfeiture option is invoked immediately on termination of the grace period, without the insurer having to wait for instructions from the policyowner.

Other non-forfeiture options have to be elected by the policyowner, and may be:

- Elected in advance, such that the policyowner gives the insurer the authority to implement the non-forfeiture option at the termination of the grace period.
- Elected by the policyowner at any time when he or she is unable to, or chooses not to, pay premiums that are due.

The traditional non-forfeiture options are:

Cash surrender value (CSV)

The simplest option for a policyowner who does not wish to, or cannot, continue paying premiums under a cash value life insurance policy is to surrender the contract and take the net cash surrender value. The net cash surrender value is the policy's cash surrender value (including guaranteed cash value and dividends on deposit), less any outstanding loans, loan interest and/or premiums unpaid. Of course, the policy, and all attendant benefits, would be cancelled. In that respect, taking the cash surrender value is not really a "non-forfeiture option" in that every element of the contract would be forfeited except for its net cash surrender value.

Example: Paolo owns a $100,000 face amount whole life participating life insurance policy with an $8,000 cash surrender value. The policy requires annual premium payments of $900 and its guaranteed cash surrender value is currently growing at a rate of about $300 a year. In addition to the base coverage, the policy has a waiver of premium rider and a $50,000 guaranteed insurability option, exercisable every five years.

Paolo has decided that he no longer needs, nor can he afford, the coverage and instructs the life insurance policy to cancel the contract and pay him the cash surrender value of $8,000. As a result, Paolo no longer has any rights under the contract, including the guaranteed right to purchase additional coverage in the future without having to prove insurability (the GIO).

Automatic premium loan (APL)

The automatic premium loan provision is usually the default option under the terms of the life insurance contract. It will automatically be invoked by the life insurance company, unless the company has received instructions to the contrary from the policyowner. The automatic premium loan provision will be invoked if:

- A premium due has not been paid.
- The 30-day grace period has expired.
- The policy cash surrender value is at least equal to the premium due.
- The policyowner has not instructed the insurance company to the contrary.

Under the automatic premium loan option, the insurer "pays" the premium due by borrowing against the cash surrender value of the contract. The loan and all accrued interest on the loan remain a charge against the proceeds of the policy (either the cash surrender value or the death benefit, as the case may be) until they are discharged by the policyowner or until the policy matures or lapses,

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whichever comes first.

Under the automatic premium loan provision, all benefits, terms and conditions of the policy remain in full effect (except for the above-noted charge against the policy proceeds), including the payment of dividends, the growth in cash surrender value and all riders.

Ideally, the automatic premium loan provision should only be employed in circumstances where the policyowner expects to be in a position to resume paying policy premiums in the near future. Because all policy benefits remain in full force, the APL is a very "expensive" means of maintaining the contract and could result in the lapse of the contract as a whole much more quickly than either the paid-up option or the extended term option. (See below.)

Example: If Paolo had not wished to cancel the policy, but was currently unable to meet his premium commitments, he could have elected to place the policy on APL and the annual premium of $900 would be paid by the insurance company taking a loan against the contract and the full coverage (including the waiver of premium and the GIO) would remain in force for as long as the policy's CSV could continue to support the $900 annual premium loans.

Reduced paid-up coverage (RPU)

Under the reduced paid-up option, a portion of the entire policy will remain in effect, permanently. In effect, a smaller policy than the original (but otherwise identical to the original base policy) with cash surrender values and dividends (if applicable) will be maintained, even though the policyowner is no longer paying premiums. Typically, all riders and additional benefits associated with a life insurance policy are cancelled if the policy goes RPU.

Example: Alternatively, Paolo could have elected a permanent solution to maintaining insurance coverage without having to pay premiums by selecting reduced paid-up coverage. In Paolo's case, the policy could support itself indefinitely, without a further injection of premiums, if the face amount of coverage were reduced to $54,000 (from its present level of $100,000). Of course, the waiver of premium rider and the GIO would be cancelled.

Extended term insurance

The extended term insurance (ETO) option provides for full insurance benefits, with no cash surrender values or other values, for as many years as the cash surrender value at the time the option is invoked will purchase. All riders and supplementary benefits are cancelled when a policy goes on ETO, only the face amount of death benefit coverage is maintained.

In the case of non-participating policies, where the cash value of the policy at any given point in time can be known in advance, the extended term insurance values are usually published in a table in the policy, based on the policy year.

In the case of variable cash value contracts, like participating whole life insurance plans, where dividends are reinvested in the policy by way of paid-up additions, the ETO values will be computed by the life insurance company, based on the net cash surrender value of the policy as a whole at the time the ETO is to be implemented.

The major advantages of the extended term options is the fact that the entirety of the policy death benefit may remain in force for a long period of time, increasing the likelihood that the full value of the insurance coverage will still be available when it is needed. Depending on the cash surrender values of the policy, however, the ETO may not provide permanent protection.

Example: Lastly, Paolo could have elected to maintain the full $100,000 of coverage for as long as possible, by selecting the extended term option. In this case, the table in the policy indicates that the coverage could remain in force for an additional 33.6 years without further payment of premiums. Of course, the waiver of premium rider and the GIO would be cancelled.

NOTE: In the case of a universal life insurance contract, traditional non-forfeiture options do not apply. Since there are normally no contractually required premiums under a universal life contract, the policy grace period only comes into play in the event that the policy has insufficient net cash surrender values to support the current monthly mortality and expense deductions. At that point, since the policy would have little or no net cash surrender values, there would be no values to support any of the non-forfeiture options.

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POLICY LOAN PROVISIONS

Owners of cash value life insurance contracts (whole life, universal life, etc.) typically have the contractual right to borrow from the insurance company, using the plan's cash value as collateral, under the policy loan provision. The policy loan usually cannot exceed a preset percentage (typically 90 to 100%) of the policy's current net cash surrender value, less an allowance for one year's interest on the loan and, in some cases, an allowance for one year's premiums on the policy.

Example: Hanif owns a $100,000 whole life non-participating policy with the Acme Insurance Company. The contract currently has a gross cash surrender value of $8,000 and an outstanding loan of $3,000.The annual policy premium is $800. Hanif's contract has a policy loan provision that permits him to borrow up to 90% of the policy's cash surrender value, less one year's premiums and less one year of loan interest at 6%.The following is the calculation of the maximum additional loan that Hanif could take against his policy:

Cash Surrender Value	$8,000
90% of Cash Surrender Value	$7,200
Less: Current Loan	($3,000)
1 Year's Premium	($800)
1 Year's Interest @ 6% on the Total Loan	($362)
Net Loan Value Accessible	$3,038

The policyowner is not obligated to repay the outstanding loan balance, or the interest on the loan, at any time, provided the cash surrender value of the policy is sufficient to support the loan. The policyowner may, of course, pay the interest annually and/or repay the principal loan balance, in whole or in part, at any time.

If the loan, or any part of it, is outstanding at the time of policy maturity or surrender, the outstanding loan balance (and any accrued interest to date) will be deducted from the cash surrender value of the policy in order to compute the net cash surrender value payable to the insured.

If the loan, or any part of it, is outstanding at the time of the death of the life insured under the policy, the outstanding loan balance (and any accrued interest to date) will be deducted from the death benefit otherwise payable in order to compute the net death benefit payable to the plan beneficiary.

Example: If Hanif, above, had died prior to taking out his new loan and just prior to paying last year's interest on the old loan, the status of his policy would have appeared as follows:

Gross Death Benefit	$100,000
Cash Surrender Value	$8,000
Current Loan	($3,000)
1 Year's Interest @ 6%	($180)
Net Death Benefit	$96,820

Section summary

You should now be able to:

- Identify the primary characteristics that distinguish term insurance from permanent life insurance.
- Compare the advantages and disadvantages of whole life insurance to term life insurance.
- Explain the difference between participating whole life and non-participating whole life.
- List and describe the additional provisions that permanent life insurance policies generally include if they build cash value.

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5:6 UNIVERSAL LIFE INSURANCE AND INVESTMENT OPTIONS

ADJUSTABLE LIFE INSURANCE PRODUCTS

In the late 1970s and early ’80s, consumers accustomed to earning (and paying) double-digit interest rates perceived conventional life insurance products as lagging behind the investment market. Fully guaranteed life insurance products based on long-term interest rate assumptions of 4% or 6% didn’t seem very attractive when compared against Canada Savings Bonds with a 19.5% coupon.

The insurance industry’s response was to introduce so-called “new money” or “interest-sensitive” products – life insurance plans whose premiums and values were a reflection of the then-current interest rate environment. Of course, the insurance companies couldn’t afford the risk of making long-term guaranteed commitments (20, 30, 50 years or more) based on such historically high interest rates. Instead, they introduced “adjustable whole life insurance” – policies whose premiums and/or values were subject to readjustment (usually every five years) based on the interest rate environment as it stood at each adjustment date.

To fully understand the workings of an “adjustable” product, we must look at the structure of more traditional, guaranteed whole life non-participating life insurance.

Fully guaranteed life insurance: Whole life non-par

“Whole life non-par” has always been considered (next to term insurance) the purest form of life insurance. It is a fully bundled plan in that all elements of the policy are fixed, guaranteed and inter-related, based on the face amount of insurance of the policy and such underwriting factors as age, sex, health and smoker-status.

The amount of premium paid under these plans is in direct relation to the amount of coverage – as is the guaranteed cash value. From the issue date of the policy until any given date in the future, a policyholder can know exactly what his or her premiums, cash surrender values and insurance coverage would be at any other date in the future, simply by referring to the table of guaranteed values in the contract. No element of the plan ever varies.

Under such a plan, the insurance company assumes all of the risk. If interest rates were lower, mortality worse or expenses higher than projected, the insurance company is responsible for the difference, since the policyholder’s interest is guaranteed in all regards.

Of course, the insurance companies price the policies based on very conservative projections, so as to lessen their potential future risk exposure.

Adjustable whole life insurance contracts were introduced in the late 1970s to overcome the outdated image of whole life non-par plans. The adjustable plans left the door open for the insurance company to adjust one element of the contract (usually either premiums or insurance coverage) at prearranged adjustment dates. This adjustment factor allowed the insurance companies to adapt the product to changes in the investment marketplace, particularly interest rate changes.

ADJUSTABLE PREMIUMS

These plans were simple enough. The premiums (and all other elements of the contract) were guaranteed for an initial five-year period – just like whole life non-par. At the end of the five-year period, past performance and future projections (for the next five-year period) were compared to the previous pricing assumptions and the premium was adjusted accordingly: increased if the assumptions were too high and decreased if the assumptions were too low, when compared with reality.

Premium increases on these plans were generally subject to a guaranteed maximum ceiling at the time of policy issue.

ADJUSTABLE FACE AMOUNT OF COVERAGE

An alternative to adjusting the premium was to adjust the face amount. Actually, under these policies, there were three options:

- If the market outperformed the policy assumptions, the premiums were reduced for the next five-year period and the face amount of insurance was left the same.
- If the market matched the policy assumptions, both the premiums and the face amount of insurance were left the same for the next five-year period.
- If the market under-performed the policy assumptions, the policyholder had a choice: either the premiums could be

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increased or the face amount of coverage could be decreased.

The general demise of the adjustable whole life insurance concept by the end of the 1980s was the consequence of two factors:

- Most consumers became disenchanted with the product when most of the adjustments went against them – increased premiums or decreased coverage.
- The introduction and proliferation of universal life insurance products provided consumers with a far more flexible product with which to combat a variable investment environment.

The basic pricing factors of traditional life insurance products are bundled: all elements of the policy are fixed, guaranteed and inter-related based on the face amount of insurance of the policy. In the case of a universal life plan, they are unbundled – they can, to a degree, operate independently of each other.

TAX DEFERRAL

Like most cash value permanent life insurance policies, universal life offers the policyowner the opportunity to accumulate investments in a tax-exempt environment. The added advantage offered by universal life is that, because of the facility to make flexible premium deposits, the policyholder can maximize the use of that tax-deferred investment environment.

Year	Annual Deposit ($)	Cash Value ($)	Total Death ($)
1	4,000	1,033	102,925
5	4,000	13,965	116,487
10	4,000	39,914	144,687
15	4,000	72,470	173,034
20	4,000	120,478	220,478
25	4,000	188,917	288,917
30	4,000	286,448	386,448
35	4,000	425,438	525,438
40	4,000	623,510	723,510
45	4,000	905,779	1,005,779
50	4,000	1,308,036	1,408,036
55	4,000	1,863,192	1,963,192

$100,000 universal life insurance policy based on a male, age 50, non-smoker with increasing death benefit

PRICING FACTORS

The three basic factors that determine the "price" (premium costs and cash values) of a life insurance policy are:

- **Investment income:** The rate of return earned on invested capital in the hands of the life insurance company.
- **Mortality:** The actual experience of the life insurance company with regard to the death rate of the lives insured by the company, as compared to the expectations built into the company's pricing model.
- **Administrative expense:** The insurance company's cost of doing business (rent, salaries, commissions, etc.).

"Unbundling" defined

An "unbundled" policy is simply one in which the various pricing factors can be adjusted within the policy independent of each other.

For example, unbundling might mean that:

- Additional insurance coverage can be added without the policy premium being increased (or increased in proportion to the new coverage added).
- Existing insurance coverage can be increased or decreased without pro-rata changes in the policy premiums.
- Investment options can be changed to higher-yield vehicles without corresponding changes in coverage or premium.
- Premiums can be reduced, paused or stopped without any corresponding immediate change in coverage.
- The insurance company might increase its mortality deduction without the policyholder having to make a corresponding change in premium deposits.

THE ADVANTAGES OF UNBUNDLING

The main advantage of "unbundling" the elements in a universal life plan is that a policyholder can (for a while, in any event) make changes to one element of the policy without having to make corresponding changes to other elements.

Example: When Murray first married, he took out a $250,000 universal life policy, at a premium of $100 a month, to help to protect his wife in the event of his unexpected death. Four years later, the couple

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had a baby and Murray's wife decided to stay at home until the child was of school age. Murray's insurance needs significantly increased (the need to protect the baby, plus the need to replace more of his income since his wife wasn't working), but he had even less money available to commit to his insurance program. For a few years, at least, Murray was able to increase his insurance coverage to $400,000, even while decreasing his premium deposits to $80 a month.

THE TEETER-TOTTER EFFECT

Even though the various elements of a universal life plan may be unbundled, they are still interdependent.

Increasing those elements that withdraw money from the policy (additional mortality deductions caused by increasing coverage levels, changing to investment options that offer lower rates of return, etc.) without increasing the elements that add to the policy (premium deposits, investment returns, etc.) will reduce the cash value accumulation within the policy. Best case, this will result in lower future cash values than anticipated. Worst case, this will result in the lapse (termination) of the policy for lack of sufficient values to pay for expenses and mortality deductions.

Just like in physics, every action within the policy will have an opposite reaction. Decreasing premiums unilaterally will decrease cash values. Increasing coverage (mortality deductions) unilaterally will decrease cash values. Increasing investment returns unilaterally will increase cash values, etc. This is the teeter/totter effect.

THE SHORT-TERM AND LONG-TERM EFFECTS OF IMBALANCE

The teeter-totter effect is inevitable in the long term. For example, significantly increasing the amount of insurance coverage without increasing the premium deposits will, after a number of years, deplete (possibly exhaust) the policy cash values. However, in the short term, the impact may be relatively moderate. More to the point, a short-term imbalance can easily be compensated for with a long-term adjustment.

Example: In the example of Murray, above, he might keep his premiums at $80 a month for the five years that his wife remains a home. He could then compensate for the lost cash values and investment growth by increasing the premium deposits to $150 a month for the duration of the policy.

When universal life insurance was introduced to the marketplace, it was often marketed as "the only policy you will ever need."

The thinking was that the policy had so many features and was so flexible in its design that it could be adapted to any situation and so could be modified to encompass all future life insurance needs.

PREMIUM DEPOSITS

The process begins with the deposit of premium dollars into the contract.

Since universal life policies are not subject to rigid premium structures, the amount and frequency of premium deposits are (within limits) determined by the policyowner.

Most policies require a minimum deposit stream for the first few years (to ensure that the policy will remain in force for at least 10 premium-paying years) and will also not accept premium deposits greater than a prescribed maximum (to ensure that the policy remains tax-exempt).

PREMIUM TAX

Each dollar of premium deposited to the policy is subject to a provincial premium tax (usually in the range of 2%), such that about 98% of premium dollars are actually deposited to the contract account value itself.

OTHER CHARGES

In addition to the premium taxes, a few insurance companies deducted a front-end load from deposits, usually only in the first – or first few – policy year(s), of anywhere from about 2% to 7% of the premium. Back-end charges (only charged at policy surrender) are more common. Such charges are paid for expenses incurred by the insurance company for issuing and maintaining the policy, including the commissions paid to the agent who sold the policy.

PLAN STRUCTURE

The policy itself is a form of "buy-term-and-invest-the-difference" concept, all within the structure of one concept. Universal life has often been compared to "a

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bag of money" to which life insurance has been attached. The insurance and the investment elements of the policy have a symbiotic relationship: the investments pay for the insurance coverage (and other charges) and the existence of the insurance elements permits the investment growth to accrue within a tax-deferred environment.

INVESTMENTS

Within the account value of the policy, the investments are typically divided into two categories:

- **Tax exempt:** The investments accrue within a tax-deferred portion of the policy and typically offer such options as savings deposits, term deposits and interest-bearing accounts that are linked to the performance of stock (or other) indices.
- **Annually taxable:** Typically invested in segregated funds, these accounts are subject to annual tax reporting to the policyowner of net interest, dividends and realized capital gains and losses.

DEDUCTIONS

Each month, deductions are taken from the account value for any or all of the following:

- Mortality charges (insurance) for one or more lives insured.
- Administrative fees.
- Riders, which are amendments to the policy that either add or limit benefits.

DISBURSEMENTS

Aside from the payout of death benefits, funds may be obtained from the policy by the policyowner through:

- Policy loan.
- Cash withdrawal.
- Partial or full surrender of the policy.

Strengths and weaknesses of universal life

FLEXIBILITY

Flexibility can be defined as the ability of the policy to be molded into virtually any form needed at policy issue. The plan can cover one or more lives insured, with different face amounts of coverage, and can be based on a wide range and duration of premium payments. It can be designed to mimic almost any type of insurance: term, term to 100, limited pay life, whole life insurance or an endowment plan.

This flexibility, combined with adaptability, makes universal life the favourite of many agents – who only have to learn one policy in order to have a "full slate" of permanent insurance products at their fingertips – and many clients – who like the idea of being able to resolve all of their insurance needs, present and future, under one umbrella.

ADAPTABILITY

"Adaptability" is the facility for the policy to be modified at any time in the future to accommodate the policyowner's changing needs for coverage or ability (or desire) to pay premiums. The policyholder can decrease or increase (subject to underwriting) coverages, increase or decrease or stop premium payments, add or delete coverages and adapt investment options to suit changing needs, a changing ability to pay or a changing investment environment.

CONTROL BY THE POLICYHOLDER

What most policyholders like most about universal life is the degree of "control" that it affords them; rather than having to turn their investment dollars (premiums) over to the insurance company to invest, the policyowner has the opportunity to direct the amount and frequency of investment and the funds or other vehicles into which the funds will be invested.

HIGHER ADMINISTRATIVE AND OTHER COSTS

One of the prices to be paid for the degree of flexibility and adaptability offered by universal life, and for the vast amount of computer resources needed to support the contract, is much higher administration expenses than are required for more traditional policies.

COMPLEXITY

A further "price" associated with universal life is its complexity. It is a very difficult product to both understand and monitor. In fact, in many instances, the policy offers too much choice. Faced with a myriad of design options at policy issue, the prospective policyowner may find it virtually impossible to make a decision. "Analysis paralysis" takes over and the policyowner never does buy because he or she can't decide what to buy.

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The role of the agent is to custom design a policy for the client, emphasizing only those features of the contract that are appropriate for the client's particular circumstances, so as to "focus" the buying decision process.

This complexity also makes the policy more difficult to manage, in that the number of options available to modify an in-force policy (different premium levels, premium patterns, investment options, coverage levels, etc.) can make the decision-making process rather daunting for policyowners.

This, again, mandates special attention on the part of the selling or servicing agent, to ensure that the policy is adaptable to changing circumstances, such that it keeps on track with the client's initial core objectives.

SELF-DIRECTED INVESTMENTS

Part of the "control" element of universal life is the variety of investments offered and the leeway they offer the policyholder to adapt to changes in investment performance. As noted above, typical investment options include:

- Savings accounts.
- Guaranteed term deposits (for terms of one to 10 years).
- Funds that track specific market indices.
- Segregated or mutual funds.

Death benefit options

One of the factors that contributes significantly to the flexibility of universal life is the fact that most policies offer a series of death benefit options at time of policy issue. Although not all options are offered by all insurers, the most common choices are:

- Level death benefit.
- Level death benefit plus account value.
- Level death benefit plus accumulated deposits.
- Indexed death benefit.

Each of these death benefits has its own, unique set of features and offers a variety of advantages to the policyowner.

LEVEL DEATH BENEFIT

As the name implies, the death benefit payable under this option remains level for the life of the plan. For example, if the death benefit were $100,000 at time of policy issue, it would still be $100,000 10 years later, 20 years later and whenever the life insured might die.

The amount of "risk" in a universal life insurance policy is defined as the amount of the death benefit payable, less the amount of the policy reserves (account value). As premiums are deposited to the plan and the account value increases, the amount of risk declines. Since the insurance charges deducted from the plan (mortality deductions) are partially a function of the amount of risk in the policy each month, a reduced amount of risk will in turn lead to lower mortality deductions. And lower mortality deductions will in turn result in higher account values and so on.

This is reflected in the following chart:

Year	Death Benefit	Account Value	Risk
1	$100,000	$800	$99,200
2	$100,000	$1,200	$98,800
3	$100,000	$1,750	$98,250

The level death benefit option requires the lowest mortality deduction charges to maintain the insurance coverage since the charge is levied against an amount at risk that is equal to the death benefit less the account value. One disadvantage of the level death benefit option is the fact that the beneficiary only receives the flat death benefit amount, regardless of the amount of premium paid by the policyowner. A high policy account value reverts to the insurer at the death of the life insured under the policy.

LEVEL DEATH BENEFIT PLUS ACCOUNT VALUE

Under this option, the account value of the policy is added to the initial face amount of death benefit, at any time, to generate the total death benefit payable.

The amount of risk under a level death benefit plus account value universal life insurance policy always remains static: equal to the initial face amount of death benefit at the time of policy issue.

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This is reflected in the following chart:

Year	Death Benefit	Account Value	Risk	Total Death Benefit
1	$100,000	$800	$100,000	$100,800
2	$100,000	$1,200	$100,000	$101,200
3	$100,000	$1,750	$100,000	$101,750

In terms of mortality deductions, the level death benefit plus account value option requires the highest mortality deduction charges to maintain the insurance coverage since the charge is levied against the amount at risk, which is always equal to the death benefit. The amount of risk being paid for never declines. A major advantage of this death benefit option is the fact that the beneficiary receives both the initial face amount and the account value as part of the total death benefit payout at the time of the death of the life insured: the account value is not "lost" to the insured. This could be particularly attractive in situations where the policyowner has deposited significantly higher premiums into the policy than are required simply to cover the current mortality and expense charges.

LEVEL DEATH BENEFIT PLUS ACCUMULATED DEPOSITS

Under this option, the value of the accumulated premium deposits into the plan is added to the initial face amount of death benefit, at any time, to generate the total death benefit payable.

The amount of "risk" under a level death benefit plus accumulated deposits universal life insurance policy will be variable, equal to the initial face amount, plus the accumulated premium deposits to date, less the account value.

This is reflected in the following chart:

Year	Initial Death Benefit	Accumulated Premium Deposited	Account Value	Risk	Total Death Benefit
1	$100,000	$2,000	$800	$101,200	$102,000
2	$100,000	$4,000	$1,200	$102,800	$104,000
3	$100,000	$6,000	$1,750	$104,250	$106,000

In terms of mortality deductions, the level death benefit plus accumulated deposits requires higher mortality deduction charges to maintain the insurance coverage than the level death benefit option since the charge is levied against the net amount at risk, plus the accumulated premium deposits. A major advantage of this death benefit option is the fact that the beneficiary receives both the initial face amount and the accumulated deposits, a sort of "return of premium" benefit but only at the time of death of the life insured. Again, this could be particularly attractive in situations where the policyowner has deposited significantly higher premiums into the policy than are required simply to cover the current mortality and expense charges.

INDEXED DEATH BENEFIT

Under this option, the initial face amount of death benefit is indexed annually, either by a predetermined percentage or by an amount tied to an outside indicator, such as the consumer price index (CPI).

The indexing is usually calculated on a compound basis and will be subject to restrictions, such as:

- The rate of indexing is not to exceed 8% annually.
- The total amount of death benefit added to the policy shall not exceed two times the initial face amount.

The death benefit added to the plan as a result of indexing is not subject to medical underwriting.

The amount of "risk" under an indexed death benefit universal life insurance policy will be variable, equal to the initial face amount, plus the indexing death benefits, less the account value.

This is reflected in the following chart:

Year Benefit	Initial Death Benefit	Index Factor	Account Value	Risk	Total Death Benefit
1	$100,000	0%	$800	$99,200	$100,000
2	$100,000	3.5%	$1,200	$102,300	$103,500
3	$100,000	2%	$1,750	$103,820	$105,570

The indexed death benefit option requires higher mortality deduction charges to maintain the insurance coverage than the level death benefit option since the charge is levied against the net amount at risk, which is calculated based on an increasing amount of death benefit. A major advantage of this death benefit option is the fact that the overall death benefit of the policy can be designed to match an increasing liability, like the capital

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gains taxes payable at death on a piece of property that is expected to increase in value at a fairly steady rate over the course of a number of years.

Mortality options

In addition to different death benefit options, many universal life policies offer two options for the type of mortality deduction used to support the plan:

- Yearly renewable term.
- Level term (term to 100).

Universal life mortality deductions

Universal life policies generally have mortality deductions based on either:

- Yearly renewable term (YRT), a premium structure that is recalculated annually, based on the attained age (and other underwriting factors) of the life insured.

or

- Level term (term to 100 or T-100), where the mortality deduction is level for the life of the policy.

MORTALITY DEDUCTION LEVELS

- YRT deductions are, comparatively, very low at the time of policy issue. A typical YRT deduction pattern increases fairly gradually each year for the early years after policy issue and very rapidly in the latter years.
- T-100, on the other hand, will have a somewhat higher mortality deduction at policy issue than would YRT, but the deduction remains level, so that it will be much lower than the YRT deductions in the later policy years.

GUARANTEED VERSUS ADJUSTABLE RATES FOR MORTALITY DEDUCTIONS

Because so many elements of a universal life insurance contract can be variable (premium amounts and frequency, coverage levels, investment rates, etc.), policyowners often look for as many contract guarantees as possible, to provide some measure of assurance regarding future performance of the policy.

The companies offering universal life insurance policies, on the other hand, often wish to minimize the number and scope of guarantees offered, to afford themselves room to compensate for future changes in anticipated mortality, operating expenses, etc.

One area of frequent tradeoffs between consumer guarantees and insurance company flexibility is that involving the monthly mortality deductions charged under the contract, particularly where yearly renewable term (YRT) rates are employed.

While realizing that these rates will increase annually with increases in the age of the life/lives insured under the policy, clients would like to see guaranteed future rate schedules, similar to the rate schedules found under many stand-alone renewable term contracts.

The insurance companies, on the other hand, would prefer for these rate schedules to be unrestricted, giving them the ability to increase future mortality deductions, to possibly compensate the insurer for under-performance (vis-à-vis expectations) in other areas of the policy or of their corporate operations.

The tradeoff between these two positions often is for the insurance companies to offer a “current” mortality deduction rate schedule, with the facility for the insurer to modify the deductions actually charged in the future, if necessary, subject to a cap on the amount that the rates could be increased.

Example: The XYZ Insurance Co. publishes a current schedule of present and future mortality deductions (per $1,000 of risk in the policy), with the caveat that the company reserves the right to increase the published rates by as much as 50% in the future, as required. Thus, a published rate in year 10 of the contract of $4.80/$1,000 could actually be increased to as high as $7.20/$1,000 ($4.80 x 150%) or any amount in between these two figures.

Agents, and their clients, need to pay particular attention to whether or not the mortality rates published by the insurance company are guaranteed in the future or are subject to open-ended or restricted increases and, if the latter, the range of those potential increases (for example, 25%, 50%, 100% of the current schedule, etc.).

The amount of the monthly mortality deduction can have a dramatic impact on the values (and ultimate viability) of a universal life insurance policy, particularly as the life/lives insured grow older and increases in the YRT deductions become very pronounced. Insurers can

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provide policy illustrations based on both the "current" and the "maximum" mortality schedules used under their universal life insurance policies, so that potential policyowners might understand the possible impact of a mortality rate scale change.

CASH ACCUMULATION: SHORT-TERM AND LONG-TERM

- Universal life policies using a YRT mortality structure will have a greater cash value accumulation in the earlier policy years (when mortality deductions are low) and lesser cash value accumulation in the later years (when mortality deductions may even exceed both the planned premium deposits and the investment income of the policy).

- Conversely, universal life plans employing T-100 mortality deduction will have relatively lower net cash value accumulations in the early years, but much higher accumulations in the later years.

Cash Value			
Year	**Annual Deposit**	**YRT ($)**	**T - 100**
1	$1,970	$789	$480
5	$1,970	$8,685	$6,968
10	$1,970	$24,019	$20,105
15	$1,970	$42,913	$36,603
20	$1,970	$69,801	$60,820
25	$1,970	$107,079	$95,331
30	$1,970	$157,997	$144,512
35	$1,970	$227,121	$214,545
40	$1,970	$319,472	$314,476
45	$1,970	$438,518	$456,812
50	$1,970	$589,588	$659,652
55	$1,970	$771,244	$948,716
60	$1,970	$852,973	$1,360,657
65	$1,970	$1,214,690	$1,938,182

Female, age 40, non-smoker, $100,000 life insurance

CROSSOVER POINT

There are actually two "crossover" points when comparing otherwise identical universal life insurance policies: one employing YRT mortality rates and one employing T-100 rates.

- **Deduction crossover:** Generally, about 10 to 15 years after policy issue (depending on the age of the life insured), the mortality deductions for a YRT mortality deduction will be equal to the deductions for T-100.
- **Cash value crossover :** Generally, after about 20 years, the cash values in a policy employing YRT mortality deductions and a similar policy employing T-100 mortality deductions will be equal.

LAPSE

- It may be that a universal life policy employing YRT mortality deductions will lapse when the life insured is in his or her late 70s or 80s. In many instances, the exceptionally high deductions required for YRT mortality on elderly lives insured will far outstrip premium deposits and investment growth. If the policy cash value is ground down to "zero," the policy will lapse.
- T-100 mortality deductions, on the other hand, remain level for life. As a consequence, the draw against the cash value of the policy will be significantly lower (than for policies using a YRT deduction), thus substantially reducing the risk of lapse. In fact, if the guaranteed rate of return on investments within the policy generates sufficient income to cover the guaranteed mortality deductions and maximum expense charges, the policy can be guaranteed never to lapse, even without additional premium deposits.

UNIVERSAL LIFE INVESTMENT OPTIONS: GUARANTEED VERSUS VARIABLE

TAX-EXEMPT INVESTMENTS

The funds invested within the tax-exempt portion of a universal life insurance policy (those exempt from current taxation) may be either guaranteed or variable.

The guaranteed investments are typically some form of term deposit (a daily interest account, a T-bill account, term deposits for terms of one to five or 10 years, etc.). These investments guarantee to return the investor's (the universal life plan itself and, by extension, the policyowner) invested capital, with interest. The interest rate paid on these investments may be guaranteed or variable and may be paid to the UL policy or compounded within the deposit. In the case of the longer-term deposit investments, a minimum interest rate (2% to 4%) will usually be guaranteed at time of reinvestment of matured deposits.

In addition to the traditional deposit investments found within the exempt portion of a universal life plan, there

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may also be deposit accounts that are linked to the performance of an outside indicator, such as the TSX index. These deposit accounts will reflect the performance of the outside indicator, often on a daily basis.

For example, if the linked deposit account holds $10,000 today and the TSX index rose 2% today, a like amount of interest would be paid into the account and the opening balance of the linked deposit account tomorrow would be $10,200. On the other hand, if the TSX declined by 2% today, the opening balance of the account tomorrow would have been reduced to $9,800, due to the charging of negative interest, to reflect the performance of the TSX index.

ANNUALLY TAXABLE INVESTMENTS

Funds that cannot be invested in the exempt portion of a universal life insurance policy because they would impair the plan's tax-exempt status are often deposited to an annually taxable "side fund" account instead. While monies are invested in this fund, any net interest, dividends or capital gains realized annually on the funds will be reported to the policyowner on a flow-through basis. Typically, the side fund is invested in the segregated funds of the insurance company that issued the universal life insurance plan, although other types of investments (Treasury bill accounts, term deposits, etc.) are possible.

Other features of universal life

EARLY CASH WITHDRAWALS

One unique feature of universal life insurance policies is the policyowner's ability to withdraw funds from the cash surrender value of the plan. Withdrawals constitute a disposition for income tax purposes, but will also affect the policy in two other ways.

First, funds withdrawn from the contract are no longer available to be invested within the contract. As a consequence, the tax-deferred investment growth within the policy will be slowed down. In fact, if the withdrawal is large enough in relation to the overall cash surrender value, it could ultimately result in the policy lapsing, for want of sufficient CSV to support the monthly withdrawals for mortality costs and administrative expenses.

Second, the overall death benefit of the plan is reduced by the amount of the withdrawal, to ensure that the insurance company does not have to assume more risk as the reserves within the policy are drawn down by cash withdrawals.

Example: Tomas owns a level death benefit universal life insurance policy with a face amount of insurance of $100,000 and a cash surrender value of $12,000. There is $88,000 of net amount at risk ($100,000 – $12,000) in this particular policy. If Tomas were to withdraw $5,000 from the cash surrender value of the policy, his cash surrender value would be reduced to $7,000 and the face amount of insurance would be reduced to $95,000.This would keep the net amount at risk in the policy the same as it was before the withdrawal, $88,000 ($95,000 – $7,000).

LOANS

Policy loans do not have the same negative effects on a universal life insurance policy as do withdrawals. As with a withdrawal, the amount of the loan will reduce the overall net cash surrender value and death benefit of the policy – because the loan must be discharged first, before any benefits are paid to the policyowner or the beneficiary.

However, when money is borrowed against the policy, the account value of the plan is not reduced, so full values continue to be invested within the tax-deferred investment environment of the policy. Offset against this is the loan interest, which must either be paid annually or accrued against the cash surrender value and death benefit of the policy.

LEVERAGING

Some banks will accept a collateral assignment of the cash surrender value and death benefit of a universal life insurance policy as security for a leveraged loan or series of loans. Under a collateral assignment, the bank will register an assignment against the policy with the life insurance company for the value of the loan it has issued. The principal and the interest on the loan do not have to be repaid to the bank during the lifetime of the life insured. Instead, all regular loan payments and interest accrue against the policy values until the death of the life insured, at which time they are discharged out of the policy death benefit.

The advantage of this type of arrangement is that the policyowner can receive a series of periodic payments from the bank (the loans), tax-free, to supplement his or

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her retirement income.

The main disadvantage of leveraging is that, if the loans and accrued interest grow faster than the cash accumulation of the policy so the aggregate liability exceeds the aggregate cash value, the bank may be forced to "call" its loan and compel the insured to surrender the contract to discharge the loan. As a consequence, the policyowner would lose both the cash surrender value of the policy and all its death benefit.

Premium Offset

Premium offset (also referred to as vanishing premiums or quick pay) is a method of reducing – or possibly eliminating – a policyowner's obligation to pay the premiums on a permanent life insurance contract.

Built-up dividends and/or cash values (universal life) of a permanent plan are used to permit the policy to "pay" for future premiums or policy costs.

PREMIUM REDUCTION METHOD

In the case of a participating whole life policy, the simplest (and least aggressive) form of premium offset is the premium reduction method. After the first policy year, the annual policy dividend, if any, is used to pay part or all of the annual premium payable. The following table illustrates a theoretical scenario:

Policy Year Owner	Annual Premium	Annual Dividend	Premium Paid By Policy
1	1,000	0	1,000
2	1,000	30	970
3	1,000	45	955
4	1,000	65	935
5	1,000	95	905
16	1,000	890	110
17	1,000	940	60
18	1,000	1,000	0
19	1,000	1,070	0
20	1,000	1,100	0

This method of premium offset will often take 16 to 20 years or more before the premium is fully paid by the annual dividend.

PREMIUM OFFSET USING PAID-UP ADDITIONS (PUAS)

A more common – and more aggressive – form of premium offset is the use of the annual dividend to purchase paid-up additions (PUAs) in the early policy years of a participating policy. These PUAs have a cash surrender value and are usually participating insurance in their own right. Year by year, the PUAs build up both the cash value and the death benefit of the policy. After, for example, 10 to 12 years of this, a combination of the current annual dividend and surrender of the cash value of some of the accumulated PUAs is used to pay the annual premium.

PREMIUM OFFSET IN UNIVERSAL LIFE

In the case of tax-exempt universal life policies, which are usually non-participating, premium offset is usually achieved by paying larger than required premiums in the early policy years and then using the accumulated build-up of tax-sheltered investment to pay for all future policy expenses. In such cases, the policyowner has the option to stop paying premiums once a reasonable amount of capital and income has accumulated within the policy.

The problem

The years leading up to 1981 saw a long period of rising interest rates that resulted in annual improvement in dividend rates. However, the 1980s and 1990s saw declining interest rates and consequent declines in dividends. It was no longer appropriate to present clients with illustrations based on prior or current high interest rates. Existing whole life policyowners who had expected to stop paying premiums in eight or nine years now found that the actual offset year was likely to be the 29th year. Universal life policyowners sometimes discovered that large mortality charges (which grew along with their ages even as interest rates declined) now required large additional premium payments to keep the policies in force.

Unhappy policyowners alleged that offset was presented to them as a "guarantee" or that they were not told how even a small reduction in interest rates might dramatically increase the premium-paying period on the policies.

For example, a halving of dividend rate assumptions to 4% from 8% does much more than double the length of premium payment period, due to compounding of values. Reduced insurer earnings result in reduced dividends that purchase much-reduced paid-up additions, with reduced

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cash values, all of which compound to geometrically reduced values, resulting in much lower current and anticipated values to be applied to premiums.

In some cases, the more realistic dividends now being credited will result in a requirement for premiums to be paid until policy maturity (for example, age 99), rather than allowing premiums to "vanish."

Policyowner "cost"

Some policyowners feel that insurance will be "free" once the policy has "offset." In reality, the premiums or policy costs still have to be paid to the insurer. In the case of an offset policy, it is the accumulated value of the policy that is used to pay these amounts rather than the premiums being paid out of the policyowner's pocket. Either way, the policyowner is still using his or her own assets to pay these costs, because premium offset reduces both the cash value and the death benefit of the offset policy – or at least slows down their growth.

Section summary

You should now be able to:

- Explain the differences between guaranteed and adjustable whole life insurance.
- Compare the advantages and disadvantages of universal life insurance to other forms of individual life insurance.
- Explain the difference between yearly renewable term and term to 100 mortality costing in universal life insurance.
- Explain the benefits to a policyholder of the universal life insurance feature of unbundling the three pricing factors.
- Explain the difference between guaranteed and adjustable mortality costs in a universal life product.
- Explain the impact of investment choices on the viability of a universal life contract.
- Explain the implications of early withdrawals, loans, and leveraging of a universal life insurance policy.
- Explain premium offset.

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5:7 BUSINESS APPLICATIONS FOR LIFE INSURANCE

In general, businesses (particularly incorporated businesses) buy life insurance for the same reasons as individuals do:

- To discharge liabilities at death.
- To permit the survivors to keep operating after a death.
- To assist the survivors with reaching long-term goals.

In the case of a business, the life to be insured could either be an owner or a key employee, whose services are vital to the profitability, possibly even the survival, of the business. The "survivors" whose interest the insurance protects could be the employees, co-owners and/or the family members of a deceased owner.

Life insurance has three possible roles in business planning:

- Business continuation.
- Funding of buy-sell agreements.
- Key person insurance.

The tax treatment of life insurance proceeds may also provide additional benefits.

BUSINESS CONTINUATION INSURANCE

Succession planning is meant to ensure that a business continues to operate viably after the death or retirement of the current owner/operator(s). The point is to designate someone to take the business: a family member, an employee of the business, a business associate or even a competitor.

The purposes of succession planning include:

- To ensure that the owner, in retirement, will have adequate resources after the business has passed to the next generation.
- To ensure that the next generation is adequately provided for.
- To ensure, in some cases, that the name of the family business will be carried on as a lasting legacy.

In the case of family succession, many parents wrestle with whether to pass equal interests in the family business to all children or only to those who are actually actively involved in the business.

On the surface, equal ownership seems to be the fairest arrangement – all of the children will be treated equally.

Example: Max operates an incorporated manufacturing business and owns all of the issued and outstanding shares of his private corporation. Max has three children, two of whom work in the business and one who has a career outside of the business. When Max dies, he plans to leave one third of the shares of the business to each of his three children.

But "equal" isn't necessarily "fair." The children who are active in the business will do the work that will generate dividends both for themselves and for the sibling who does not work in the business. The children working in the business will be interested in growing it, while the one on the outside is likely to be interested in generating an income stream. Ultimately, the children will be at loggerheads.

More important than ensuring that all the children are treated equally is ensuring that all children involved in the business are treated fairly.

Example: Max could avoid family squabbles that could impair the ability of the business to function by leaving 60% of the shares to the eldest child, who is very active in the business, 40% to the younger child, who is less active in the business, and none of the shares to the other child who is not active in the business.

What, then, about a child who is not employed in the business? The easiest solution would, of course, be if the owner had sufficient assets to pass along to other children, to "equalize" their benefits.

Example: Max's company is worth $3,000,000. He also has a house and investments worth another $1,500,000. He could leave the shares of the business to the two children working in the business and $1,500,000 worth of other assets to the other child.

If the business owner doesn't have sufficient assets to go around, the next best thing is to "create" assets – through the use of life insurance.

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Example: If Max owned nothing but the shares in his $3,000,000 company, he could equalize his children's estate interests by leaving $1,500,000 worth of shares to two of his children and then take out $1,500,000 worth of life insurance, payable to the third child, to equalize their inheritances.

Of course, this solution requires a considerable premium outlay and results in a substantial increase in the value of the estate.

A less expensive solution would be to place the child who is not in the business in the same position he or she would have been in had he or she shared equally in the value of the business – and leave the business itself to the other two children.

Example: If Max had left the $3,000,000 business equally to his three children, they each would have received $1,000,000 worth of shares. To satisfy the child not involved in the business, Max needs only to leave him or her $1,000,000 of insurance.

The child outside of the business would lose nothing. The children who inherit the business would each gain $500,000 more, but they have to work the business to turn a profit, while their sibling only needs to invest the insurance proceeds.

NOTE: To make this solution even more practical, the business could pay for the insurance premiums, so that – indirectly – the value of the business will be reduced by the value of the premiums paid and, indirectly, the children who inherit the business will have paid for the insurance solution.

BUY-SELL AGREEMENTS

Buy-sell agreements ensure that a deceased business owner's heirs receive full value for the business and that the surviving partners/shareholders can carry on the business without the outside influence of the deceased's family. The point of a buy-sell agreement is to ensure there will be a ready market, at a fair price, for the owner's share of the business.

All buy-sell agreements should include:

- **A guaranteed purchaser:** The most logical buyers are likely to be the surviving business partners. Thus, the buy-sell agreement is generally entered into by all of the owners of the business, with the survivors promising to purchase the share of a deceased owner.
- **A guaranteed sale:** The flipside to having a mandatory purchaser is also to make it mandatory that the estate of a deceased business owner is bound to sell the business under the terms of the agreement. If the agreement is not mandatory on both the buyer and the seller, the seller could hold out for better terms of sale.
- **A guaranteed purchase price:** A binding agreement of purchase and sale is not worth much unless the price (or at least a method to determine the price) can be determined in advance. Since business values can be expected to change over time, a fixed price in the agreement is usually not practical, as it would have to be updated regularly. More practically, the parties will usually agree on a pricing formula or a designated outside professional valuator to set the price at the time of the death of one of the owners.
- **Guaranteed funding:** The purchaser could:
  - use personal assets;
  - borrow funds;
  - pay off the purchase price over time, in instalments, ideally out of company profits: or,
  - place life insurance on the life of the vendor and use the insurance proceeds to fund the buy-sell agreement.

NOTE: In the case of an insurance solution, since the parties do not know, upfront, who the purchaser(s) will be and who the vendor will be (who will die first), all of the co-owners of the business must be insured for an amount consistent with their ownership interests in the business.

- **An activation agreement:** When the buy-sell will be triggered, for example, on death, disability or retirement.

KEY PERSON INSURANCE

The success of a closely held business often depends on the services of key owners and employees. The loss of key services due to death will probably result in a loss of income to the business, at least temporarily. In addition, increased expenses could result from these circumstances, since a replacement employee may have to be recruited at a higher salary and require extensive training. This key employee exposure should be considered in the risk-management process.

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The first step in handling this risk is to identify who the key employees are.

Owners are usually material participants in the business and can be classified as key employees, but beyond the owners, the key employee risk is often overlooked.

Key employees may:

- Have a specialized skill critical to the success of the business. The skill may be possessed by potential replacements, but replacement employees might have to be recruited at higher salary levels.
- Have a significant customer or client base and is responsible for attracting significant amounts of business.
- Be a source of capital if their loss would damage the credit rating of the closely held business.

Determining the key employee's value to the closely held business is even more speculative than the valuation of the business itself. The actual valuation method employed depends on the characteristic of the employee in question.

There are several methods of valuing a key employee. Four of the most commonly used approaches are:

- To apply some multiple to a key employee's salary.
- To capitalize, at some discount rate, the corporate earnings traceable to the key employee's efforts, skills, knowledge, talents, contacts or other attributes.
- To estimate the percentage reduction in the firm's going-concern value that would result from the loss of the key employee and to multiply that percentage by the firm's going concern value.
- To employ the unscientific assumption that the maximum amount of coverage an insurance company will issue on the key employee equals that employee's worth.

Example: A business has $500,000 of tangible assets and generates $100,000 a year in net income. Similarly situated businesses have a rate of return on tangible assets of 10%. In this case $50,000 of income can be attributed to capital and $50,000 of income can be attributed to goodwill and the management skills of the key employee. We can capitalize the $50,000 of earnings at the 10% expected return rate and reach a value for the key employee. The capitalization factor in this case is 10 (100 /10).

Net income attributed to goodwill x capitalization factor = value of goodwill resulting from employee

$50,000 x 10 = $500,000

In this case the key employee's value to the business is $500,000.

The value of a key employee is usually more difficult to determine than was seen in the example above. The firm may have to consider various subjective factors to determine an approximate value for the key employee. For example, the firm should consider replacement salaries and the training required for another employee to become effective. A simple approach might be adequate in many circumstances, but many business owners may want to be more precise in valuing key employees.

A conceptually sound approach to key employee valuation should:

- Be forward-looking: What will the key employee produce in the future?
- Take into account the timing of the key employee's contribution to the firm.
- Recognize that the key employee's contribution to the firm may rise or fall over time.
- Recognize that the key employee's contribution to the firm will eventually end – even if the employee doesn't die, become disabled or resign before then – and that he or she will have to be replaced.

Key employee life insurance

A business could purchase insurance on the life of the key employee to cover the risk of income loss and/ or increase in expenses resulting from death. Term insurance can be purchased if the primary concern is the key employee's dollar value to the business. Decreasing term could be appropriate because the key employee exposure decreases as the insured approaches retirement, since the business can be expected to have his or her services for a fewer number of years.

Key employee insurance, however, is usually coupled with some other purpose, such as providing a retirement benefit for the key employee. Permanent, cash-value life insurance is typically purchased to meet this objective. The life insurance death benefit will be received by the

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business as indemnification for the income loss and/or increase in expenses resulting from the key employee's death. If the insured survives until retirement, the corporation can use the cash surrender value to help fund a retirement benefit.

Another approach would be for the business to transfer the policy to the employee at retirement. The business should be the owner and beneficiary of key employee life insurance. This should pose no insurable interest problems since the business will suffer a pecuniary loss at the death of the key employee. The premiums for key employee insurance will be non-deductible by the corporation.

LIFE INSURANCE PROCEEDS PAYABLE TO THE BUSINESS

As with personally owned life insurance, death benefit proceeds payable to a corporation are tax-free. This means that the business has the advantage of being able to plan for contingencies at the death of an owner or key employee based on the gross insurance proceeds.

In the case of a corporate beneficiary (for example, a closely held private corporation) the insurance proceeds might be intended to defray costs:

- **Directly** (within the business): to discharge corporate debt or hire a replacement employee.
- **Indirectly** (via the surviving shareholders): to replace lost corporate earnings or fund a buy-sell arrangement.

If the insurance proceeds need to be utilized at the shareholder level, the proceeds (or most of them, in any event) can be distributed from the corporation to the shareholders as a tax-free capital dividend, via the corporation's capital dividend account.

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Section summary

You should now be able to:

- Discuss why a business generally purchases life insurance.
- Explain the nature of business continuation insurance.
- Explain why a buy-sell agreement might be an important part of a business continuation insurance plan for a closely held business.
- Explain the benefits to the business of purchasing key person life insurance.

5:8 POLICY BENEFITS AND RIDERS

A rider (also sometimes called an endorsement) is an amendment to the policy that either adds additional benefits to the contract or limits the benefits otherwise payable (an exclusion rider).

Typical riders adding new, or expanded coverage to a base life insurance policy include:

- Waiver of premium.
- Parent's waiver of premium.
- Accidental death and dismemberment.
- Monthly disability benefit.
- Accelerated death benefits.
- Guaranteed insurability.
- Term insurance riders.
- Paid-up additions.

WAIVER OF PREMIUM

Total disability waiver of premium (TDWP) may be attached to a policy on payment of an extra premium. This rider usually provides for the regularly scheduled premiums to be waived if the life insured becomes totally disabled due to sickness or accident, prior to a predetermined age (60 usually). In the case of a universal life policy, the waiver or premium benefit usually waives the monthly mortality and expenses charges ordinarily charged under the contract for the period of disability (although some plans provide that the insurance company will make limited, scheduled deposits to the plan in the event that the life insured is disabled).

The life insured must remain so disabled for at least three to six consecutive months (depending on the rider). If so, the insurer will pay all premiums as they fall due while the life insured remains totally disabled. Usually, any premium already paid by the policyowner during the first three to six months of total disability is refunded.

The plan continues to accrue all benefits (cash value growth, dividends, riders, etc.) while the life insured is disabled. In event of death, the sum insured will be paid in full, just as if the policyowner had continued to make premium payments.

The waiver of premium rider typically excludes claims for disabilities due to specified causes, such as:

- Self-inflicted injuries.
- Injuries caused by war or act of war.
- Injuries or illness due to pre-existing conditions.

Convertible term policies may be converted to permanent insurance while the life insured is disabled and the premiums on the term plan are being waived under the waiver of premium rider. Whether the premiums payable under the new, permanent plan will continue to be waived under the rider will depend on the terms and conditions of the particular waiver of premium rider contained in the original term contract.

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PARENT'S (PAYOR'S) WAIVER OF PREMIUM

Another type of disability clause is known as parent (or payor) waiver, in the case of insurance on the lives of children. The parent waiver rider provides that, in event of the death or total disability of the parent, or other specified person paying the premiums, all further premiums will be waived, either for the duration of the disability, or for the life of the contract, or until the child reaches a specified age (usually 18 or 21), whichever comes first.

Because the insurance company is assuming a separate risk (with regard to the death or disability of the payor – rather than the life insured), the payor must provide separate evidence of insurability before this rider will be issued.

ACCIDENTAL DEATH BENEFIT

Sometimes called double indemnity, the accidental death benefit (ADB) is a further protection feature that can be attached to a basic policy. It provides that if death is caused by accident, double or triple the basic sum insured will be paid. Death by accident is defined in the policy usually as death resulting from bodily injury effected solely through external, violent and accidental means, independently and exclusively of all other causes, and occurring within 365 days after such injury.

In addition to the restrictions in this definition, the ADB clause excludes certain specific situations, such as: suicide, self-inflicted injury, war, air travel (except as a fare-paying passenger on a regularly scheduled flight), violation of the law and riot.

The additional premium charged for the ADB will depend on the life insured's age at issue and the premium-payment period. Usually this protection cannot be applied for after age 55 and the protection usually ceases at age 65, or at the earlier maturation of the policy.

There may also be a dismemberment aspect to the rider, which will pay a scheduled lump-sum benefit should the life insured lose (or lose the use of) two limbs, or the sight of both eyes, or the use of one limb and the sight of one eye, etc. As with the accidental death benefit, the dismemberment must arise from bodily injury effected solely through external, violent and accidental means, independently and exclusively of all other causes, and occurring within 365 days after such injury.

MONTHLY DISABILITY INCOME BENEFIT

Some policies may contain a rider that will provide the insured with a monthly income benefit in the event of total disability – the inability of the insured to perform the essential duties of his or her regular occupation. There is usually a three to six-month waiting period before benefits commence.

This benefit is independent of any disability waiver of premium benefit. The policy continues to accrue all benefits (cash values, etc.) while the benefit is paid and full death benefits would be paid should the life insured die. The amount of the benefit is usually a function of the face amount of the policy (for example, $10/month of income for every $1,000 of life insurance coverage).

ACCELERATED DEATH BENEFIT RIDERS

Over the past two decades, the concept of an accelerated death benefit has emerged within the life insurance industry. The principle behind this concept is that there are some circumstances where it would be unconscionable to allow a terminally ill life insured to suffer needlessly, when cash could be used to alleviate his or her suffering.

To provide the needed cash (for medical treatment, wheelchairs, to help supplement a reduced income, etc.), the insurance company will advance a portion of the death benefit: paying some now to the ill insured rather than waiting to pay all of the policy proceeds to the named beneficiary, after the afflicted life insured has died.

Any amount advanced to the insured under an accelerated death benefit (plus interest to the date of death) is subtracted from the policy death benefit otherwise payable to the beneficiary at the time of the death claim.

Presently, accelerated death benefits are typically paid with respect to any, or all, of the following:

- terminal illness,
- dread disease and
- long-term care.

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TERMINAL ILLNESS

An insured/life insured who has contracted, or been diagnosed with, a terminal illness (TI) that is expected to result in his or her death within 12 months can apply for an advancement of a portion of the death benefits. The diagnosis, and the life expectancy of the life insured, must be supported with medical evidence.

The amount of the benefit payable under the terminal illness rider is typically between 25 to 75% of the full face value of the policy (depending on the contract) and is also subject to a specified dollar maximum, such as $100,000.

Example: Matthew owns a life insurance policy on his own life in the amount of $500,000. The policy contains a terminal illness rider allowing Matthew to accelerate up to 25% of the death benefit, to a maximum of $100,000, in the event he should contract a terminal illness that would result in his death within 12 months of the date of claim.

Matthew recently found out that he has liver cancer and only has six months to live. If he wished, Matthew could receive $100,000 of the policy death benefit now, leaving $400,000 for his beneficiary.

DREAD DISEASE

The dread disease (DD) rider provides an acceleration of a life insurance death benefit, similar to the payout under a stand-alone critical illness policy.

The insured qualifies to receive (accelerate) a portion of the death benefit under the policy in the event that he or she should:

- Contract life-threatening cancer.
- Have a heart attack.
- Contract AIDS.
- Have a stroke.
- Undergo coronary bypass surgery.

Unlike the terminal illness rider, the applicant under the dread disease rider does not have to be in danger of pending death due to the contracted condition or disease. The condition does, of course, have to be supported with medical evidence from a physician.

As with the terminal illness rider, the benefit is usually paid in a lump sum and is subtracted from the ultimate death benefit payable under the policy.

LONG-TERM CARE

The long-term care (LTC) benefit is paid as monthly income to an insured who requires institutionalized or home care as a consequence of a medical condition. As with stand-alone long-term care insurance coverage, the long-term care rider pays a benefit in the event that the insured is unable to perform one or more normal activities of daily living (ADLs): eating, bathing, continence, toileting, dressing and transferring.

There may be additional requirements for a successful claim under this rider, such as: medical proof of disability, a waiting period before benefits start or an elimination period before a claim may be entered (for example, the policy must have been in force for at least one year).

The benefit is paid in monthly instalments and is based on a percentage of the policy death benefit (for example, 1% per month) for the duration of the period when the insured needs assistance or until the maximum allowable accelerated benefit (typically between 50 and 100% of the death benefit) is paid out, whichever comes first.

GUARANTEED INSURABILITY BENEFIT

To guard against the possibility of the life insured becoming uninsurable or a substandard risk, the GIB (also called guaranteed insurance option) is a low-cost rider attached to a basic policy. Its purpose is to guarantee the future insurability of the life insured. The policyowner (and/or the life insured in the case of a third-party contract) is given the contractual right to purchase additional life insurance on specified future dates or within specified periods at the time an option to purchase is exercised. Evidence of insurability is not a requirement.

GIB coverage naturally raises the problem of adverse selection in the sense that those who become substandard risks because of accident, illness or an occupation change are more likely to exercise GIB future options than will healthy policyowners. Therefore, the conditions under which the options can be exercised are designed to limit the degree of adverse selection.

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The usual conditions that apply are:

- The option to buy is seldom available more than once every other year and, in some contracts, must be exercised within 60 days.
- The maximum amount of each optional purchase (usually anywhere from 50% to 100% of the initial face amount of the policy, with an overall maximum dollar amount) is established when the GIB rider is arranged.
- The options to purchase may be exercised only between certain ages, such as 15 to 50.
- The number of options that may be exercised over the life of the policy may also be limited (for example, no more than three of the scheduled option dates may be exercised).

Many policies provide that the option amount of insurance is automatically and temporarily in force for the duration of the option period (typically 30 to 60 days) to protect the interests of the beneficiary should the life insured die during the option period without having (yet) taken up the option.

TERM INSURANCE RIDERS

A term insurance rider adds an additional level of temporary (term) insurance coverage to an existing or newly issued life insurance contract. The underlying contract may be a term insurance policy itself or some form of permanent life insurance. The term rider coverage may be on the life of the primary life insured under the contract or on the life of some third party.

An individual might wish to attach a term rider on his or her own life to an existing whole life insurance policy because there are two insurance needs: one that is temporary and one that is permanent.

Example: Scott owns both a cottage in the north and a house in the city. Both have grown substantially in value and will have capital gains associated with them when Scott dies (he expects to hold both properties for life and then pass them to his children). The cottage is debt-free, but the house has a $100,000 mortgage outstanding for the next 12 years. Scott will need life insurance coverage for the whole of his life, to pay the capital gains taxes that will be owed on one of the properties when he dies (the gains on the other can be protected by his principal residence exemption). He will also need temporary life insurance, for 12 years, to discharge his mortgage on the house, should he die before paying it off. He decides to take out a whole life participating policy with a face amount sufficient to cover the anticipated capital gains tax liability and adds a $100,000 term rider to the policy to cover the mortgage. If Scott lives to pay off his mortgage in 12 years, he could then either cancel the term rider or retain the coverage for other purposes.

The primary advantages of term riders are: simplicity of administration and reduced costs.

Simplicity of administration

The addition of term riders to an existing life insurance contract allows the policyowner to initiate different levels of coverage, or coverage on different individuals, all within one life insurance policy. The coverage is all paid for through one premium withdrawal and the policyowner has only one policy of which to keep track.

Reduced costs

In addition to mortality costs and other expenses, every stand-alone life insurance policy contains a "policy fee" – an amount (usually between $50 and $100) charged annually to cover administration expenses, regardless of the face amount of the insurance contract itself. Term riders carry no, or reduced, policy fees, since the policy fee charged on the base contract to which the term rider is attached pays for most, or all, of the administrative costs of both coverages. Thus, the administration fees associated with a policy that has a term rider would be lower than the administration fees that would be charged if the coverages were provided through two different policies.

Example: If Scott, above, provided coverage for his capital gains and his mortgage through the use of two separate policies (a term plan plus a whole life plan), he would have to pay a total of $150 in policy administration fees each year – $75 per policy. Because the term coverage is provided via a term rider attached to his whole life policy, the administration fee for the term insurance coverage has been reduced to only $25 a year. As a result, Scott only has to pay $100 a year in administration fees ($75 + $25).

Over the course of the 12 years that Scott expects to require the term insurance coverage, the use of a rider will save him $600 in administration policy fees ([$150 – $100] × 12).

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The term rider itself cannot have a term with a duration greater than the life of the underlying contract. This is not a problem when the term rider is piggybacked on a whole life policy, but could be an issue if the rider is attached to another term policy. If the base policy expires, so will the term rider expire and both coverages would be lost.

Example: Serge requires a term policy for 10 years to provide collateral protection on an extended business loan, so he takes out a 10-year non-renewable term policy on his own life. Subsequently, Serge takes out a 20-year mortgage on his house and wishes to protect the mortgage with term insurance. It would not be practical for Serge to place a term rider on his existing 10-year term policy in order to protect the mortgage, because the base policy will expire in 10 years – and so would the term rider – 10 years before his mortgage is discharged.

This problem could be rectified if the term rider has a conversion option associated with it, permitting the insured to convert the term rider to a stand-alone term (or other) policy without having to provide medical proof of insurability.

As noted above, term riders can be used to provide insurance protection in several different ways.

The primary insured
The term rider could provide additional term coverage on the primary life insured, as in Scott's case, above.

Additional lives insured
The term rider could be used to provide life insurance coverage on the life of someone other than the primary life insured (usually a family member).

Example: Ted and Anna are a married couple (second marriage for each of them) who each own and maintain separate assets has $200,000 in an RRSP, which he intends to keep tax-deferred for as long as possible, because he wants the funds to pass to his children eventually. Anna owns a successful incorporated business. She intends to sell the business and retire, eventually, but is worried about the capital gains tax that her estate would have to pay if she were to die prior to reaching retirement. Each has an insurance needed needs permanent coverage to cover the tax on the RRSP when he dies; Anna has a temporary need, to provide for the tax on the shares of her business, but only should she die before retirement. The most practical solution might be for Ted to take out permanent life insurance and add to his policy a term rider on Anna's life.

The coverage on the other insured person is underwritten separately from the coverage on the primary life insured and the amount of coverage under the term rider is usually unrelated to (may even be greater than) the amount of coverage on the primary life insured.

Spouse and children's term riders
Some life insurance contracts offer a "package deal" of coverage on the spouse and the children of the policyowner/ life insured. The coverage is generally fairly small in amount and is offered in units. Each unit usually consists of $5,000 of death benefit on the insured's spouse and $1,000 of death benefit on each of his or her children. Most riders permit a maximum of 10 or 15 units to be purchased (for example, a maximum of $50,000 of coverage on the spouse and $10,000 of coverage on each child).

The rider is underwritten on the spouse and children living at the time the rider is added to the policy. Children born subsequently are automatically added to the rider once they achieve the age of 15 days.

The spousal coverage usually lasts until age 65, at the latest. The children's coverage usually expires on each child at a predetermined age (usually 21 or 25), although the rider typically also includes a conversion option.

The premium charged for the rider is a function of the number of units purchased (regardless of whether there are one or 12 children covered) and remains level for the life of the rider, even if additional children are born or are dropped from the rider as they reach the maximum age limit.

Children's term riders
Similar to the spouse and children's rider, a person can also purchase a slightly less expensive rider that covers just the children of the insured (in recognition of single-parent families).

Coverage on the spouse and children by the use of term insurance riders insures the risk of the premature death of the spouse and/or the children. Term insurance on the spouse addresses the economic loss of the husband or wife to the family unit. Term insurance on the children

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recognizes the need to provide for the burial costs and other losses faced by the family on the death of a child.

An important feature of spouse and children's term riders is the conversion option that is usually available. The conversion option allows the spouse to obtain permanent life insurance coverage as the need arises, without having to provide evidence of insurability when the conversion takes place. This alternative could be considered on the death of the life insured under the main policy or at any time before the spouse's term coverage expires. The conversion option also allows the children to continue the coverage on their lives under a separate permanent life insurance policy. The conversion option is available to each insured child even if the child were to become uninsurable otherwise. Some policies allow each child to acquire as much as five times the coverage amount of the children's term rider.

Example: The Smiley family includes Jim and Katy and their three children, Fran, Stan and Declan. Jim is the owner and life insured under a $100,000 permanent life insurance policy. Katy is the main caregiver for the children and, recognizing the need to provide continuing care to the children if she were to die prematurely, the couple has added a spouse term insurance rider under Jim's policy insuring Kate for $25,000. Kate's coverage will continue until Jim reaches age 65. If Jim predeceases Kate her term coverage will become paid-up and she will have the option to convert the coverage to permanent life insurance.

In addition to the spouse term rider, the couple has decided to add term insurance rider coverage on each of the children in the amount of $5,000. In the event of a child's death, the insurance coverage would help to defray the burial costs. The insurance on each child terminates at his or her age 21. Each child can then choose to convert the coverage to permanent life insurance. If Fran, for example, is uninsurable when she reaches age 21, the provisions of the term rider might allow her to convert the coverage to a permanent life insurance policy for as much as five times the basic coverage, or $25,000.

PAID-UP ADDITIONS

Some whole life participating policies offer the policyowner the option of making additional premium deposits, over and above the regularly scheduled premiums. These additional deposits are invested in paid-up additions (PUAs) to insurance – little, single premium paid-up insurance amounts in their own right. These PUAs are added to the basic death benefit and cash values of the contract (in the same way that PUAs purchased under a dividend option are added to the contract). The PUAs can generally be purchased without the life insured having to provide proof of continuing insurability.

The amount of PUAs that may be added to the contract, and the maximum age of the life insured at which they can be added, are specified in the rider. Because a dollar of premium deposit will generally buy far more than a dollar (often five or more dollars) of paid-up insurance benefits, the insurers need these restrictions in order to protect themselves against anti-selection. Otherwise, poor insurance risks, or policyowners who are terminally ill, would leverage up their life insurance coverage simply by depositing more and more premium dollars into the contract.

Section summary

You should now be able to:

- Describe the supplementary benefits that may be purchased with a life insurance policy, including: AD&D, monthly disability benefit, waiver of premium, etc.
- Explain the purpose of accelerated death benefit riders and the key provisions of three common accelerated death benefits, the terminal illness (TI) benefit, the dread disease (DD) benefit and the long-term care (LTC) benefit.
- Explain the guaranteed insurability benefit, its benefits and appropriate use.
- Explain the purpose of term insurance riders to permanent life insurance.
- Explain the paid-up additions rider.

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5:9 RECOMMEND THE "BEST" PERMANENT LIFE INSURANCE PRODUCT

Despite the optimism of some of the earlier marketers of universal life, no one type of life insurance product is right for every permanent need and no one contract will always be "the only policy that you'll ever need."

As a matter of fact, provided both the need and the product are permanent and affordable, any policy issued for the right face amount and in force at the time of the death of the life insured is the "right policy."

But the features of one type of contract or another may make it more appropriate than any other type for a given client situation.

TIPS

Death benefit

- If the client only needs a level death benefit for life (to protect a fixed liability) but requires a permanent life insurance solution, either term to 100 or whole life non-participating would be the best product to recommend.
- If the death benefit needs to be able to increase over time but not necessarily at any predetermined rate, then a participating whole life policy with the paid-up additions dividend option might well be suitable.
- If the client is likely to need to increase or decrease the base amount of coverage in the future or is looking to index future increases in coverage at a predetermined rate, then universal life would likely be the best choice.

Premium flexibility

- Term to 100 and whole life policies are most appropriate for clients who have the ability to meet their ongoing premium commitments on a regular basis.
- Whole life plans also provide some premium flexibility, through non-forfeiture options.
- Universal life provides the most premium flexibility allowing premiums to be increased, deceased, paid on an irregular basis (as to both time and amount) and even stopped (for a period of time, at least).

Risk/reward profile

- Term to 100 and whole life (both par and non-par) are excellent choices for those clients who are not risk-takers with their money.
- Universal life can also be designed as an almost risk-free product, provided sufficient funding is provided and the client selects the term to 100 mortality deduction and guaranteed deposit investment options.
- Universal life also provides a multitude of investment options (linked accounts, segregated funds) for those clients who are seeking higher return potential from their investments and are willing to assume more risk to achieve it.

Tax-deferred investing

- Universal life, with its flexible premium deposits and variable cash values, offers clients the greatest opportunity to invest funds within the tax-deferred environment of exempt life insurance, although participating whole life plans offer similar flexibility, through the ability to purchase dividend option paid-up additions with extra premium deposits.
- Term to 100 and whole life non-participating plans offer no opportunity for tax deferral.

Management capabilities

- If a client has no ability or inclination whatsoever to be involved in the ongoing management of his or her insurance portfolio and there are no other significant factors to consider, either term to 100 or whole life non-participating would be the best product to recommend.
- Both types of policy have fixed premiums, fixed death benefits and no variable factors that require hands-on management. Participating whole life would be the next best choice for this client, with universal life (with all of its variable components) being least suitable.

CASE STUDIES

Some of the factors that should be taken into consideration when recommending permanent life insurance product solutions.

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Client profile 1: Norman Yates
Norman, age 62, owns $1,000,000 worth of preferred shares in a private holding company. The shares are not expected to ever change in value.

The shares have a $100,000 adjusted cost base, so Norman has a prospective capital gain of $900,000 when he eventually disposes of the shares. This will result in a tax liability of about $225,000 when Norman disposes of the shares.

Norman has a substantial guaranteed cash flow, from the dividends on the preferred shares and from other sources, so he doesn't expect to have to dispose of the shares until he dies – at which time he intends to will them to his children.

Product recommended
$225,000 of term to 100.

Rationale
The problem is permanent (it will be around for as long as Norman is around), so it needs a permanent solution.

The problem will not increase in value, so Norman doesn't need a product that will offer any form of increasing death benefit.

Norman has adequate, guaranteed cash flow such that he should have no problem paying policy premiums on a regular, long-term basis, so he doesn't need a solution with forfeiture values.

For this specific problem, Term to 100 seems to be a perfect fit. It will offer a level death benefit for a level premium, with no need for "extra" policy features.

Client profile 5: The Jeffersons
When Murray Jefferson married Inez, he took out a $250,000 term life policy, at a premium of $60 a month, to help to protect his wife in the event of his unexpected death. Murray subsequently converted the term policy to $250,000 of universal life and increased the premium to $100 a month. Four years later, the couple had a baby and Inez decided to stay home until the child was of school age. Murray's insurance needs significantly increased – to protect the baby and replace more of his income, since Inez isn't working – but he had even less money available to commit to his insurance program.

Product recommended
Increase the coverage under the universal life policy from $250,000 to $400,000 (with medical underwriting).

Rationale
Murray might be able to keep his premiums at $100 a month for the five years that his wife remains at home. He could then compensate for lost cash values and investment growth (due to funding a permanent policy with term premium deposits) by increasing the premium deposits to $200 or $300 a month for the duration of the policy. He might even be able to increase the coverage for a few years, if the couple has another baby, without increasing his premium deposits right away.

Client profile 3: Rod Sterling
Rod owns a sporting goods store in partnership with his brother, John, both of whom are in their 30s. The store is currently worth about $200,000 and is expected to grow in value.

Rod and John have a buy-sell agreement providing that each should buy out the interest of the other's estate, in the event of the death of either of them. The buyout price is currently $100,000, but that is subject to change based on periodic valuations of the business. There are just the two of them involved in the business right now, but both hope to ultimately bring their sons (who are both in university) on as junior partners. The business can afford the insurance easily enough now, but cash flow can be sporadic.

Product recommended
A universal life insurance policy with $100,000 of coverage on each partner's life.

Rationale
The policy will solve the insurance problem today and has the capacity to adapt to changes in the future, all within the framework of the same policy.

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LIFE INSURANCE PRODUCTS

The policy can permit increases in coverage (to reflect changes in the valuation of the business), the addition of other lives insured (as the two sons join the business) and can accommodate variable premium patterns (to allow for the business' intermittent cash flow).

Client profile 4: Barbara Hanna
Barb expects to have about $200,000 in her RRSP when she retires in five years. She plans to establish a registered retirement income fund (RRIF) from the value in her RRSP when she turns age 71 and take the minimum payments. You have determined that Barb has a need for about $100,000 of permanent life insurance to pay the tax on her RRSP proceeds when she dies (the RRSP will go to her two adult daughters).

It is expected that the full value of the RRSP will be intact when Barb dies. If anything, if Barb is able to repeat her past investment performance in the RRSP, it will continue to grow in value at a slow, steady pace, despite the mandatory RRIF withdrawals. She is a cautious investor, not wishing to spend much time managing her investments while avoiding risk.

Product recommended
$100,000 whole life participating insurance with the dividends used to purchase additional insurance coverage.

Rationale
Barb is looking for an uncomplicated, management-free solution to her problem. Universal life will provide the right technical solution, but may be too complicated for Barb's temperament.

She would probably be better off with a product like whole life, which is virtually management-free.

Using the paid-up additions dividend option would provide her with modestly increasing coverage, to match the expected increase in the value of her RRIF assets (and, by extension, her tax liability) and the cash values would provide the policy with a "cushion" in the event that she had to stop paying premiums for a period.

Tips for identifying the best policy to meet a client's needs

LIFE INSURANCE TYPES

For purposes of this exercise, life insurance policies can be divided into four general categories with the following characteristics:

Term insurance
- Low cost
- Limited lifespan
- No cash values

Term to 100
- Higher cost
- Level death benefit
- Usually no cash values
- Level premium for life

Whole life insurance
- Higher cost
- Level or increasing death benefit
- Cash/non-forfeiture values
- Premiums for life or limited pay

Universal life insurance
- Highest cost
- Level or increasing death benefit
- Flexible cash/non-forfeiture values
- Flexible premiums or limited pay
- Ability to maximize cash deposits

ISSUES TO CONSIDER

There are a number of competing (often conflicting) issues to consider in determining the most appropriate product type to recommend to a given client:

How long the insurance coverage is needed
If the insurance coverage is needed for a limited period

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that is likely to end well before the life insured's life expectancy, then term insurance is indicated. This could involve protecting the outstanding balance of a mortgage or other debt, protecting an education fund for children or funding a business buy/sell agreement, to mention but a few uses for term insurance. If the client's situation indicates that the insurance may be required for a permanent need at some future date, convertible term insurance may be indicated.

Convertible term insurance may also be the best solution in situations where the client has a large permanent need but a current limited ability to commit funds to a life insurance program. The coverage can be converted to permanent coverage at a later date, as the client's financial circumstances improve.

Affordability

If the client has a permanent need that could be met with a level death benefit policy and price is an issue, term to 100 should be selected to keep premium costs as low as possible. If price is not an issue, the client should consider whole life or universal life, if those products offer benefits (cash and non-forfeiture options) that more effectively meet the client's needs.

Level or increasing coverage needed?

If the insurance need is likely to remain level for the life of the covered liability, almost any type of insurance policy can meet the need. However, if the need is likely to increase in the future (such as the tax liability at death on a growing RRSP or capital asset), an indexed policy may be called for. Alternatively, the client might consider a whole life policy with the paid-up additions dividend option or universal life insurance. In any event, a policy with a guaranteed insurability option should be selected.

Ability/desire to pay premiums for life

For clients who need permanent coverage but do not wish to pay insurance premiums for life, either whole life or universal life should be recommended. In either policy, the client has the option to let policy values (dividends or the account value) pay the policy premiums/costs on behalf of the client.

Need for flexibility

If the client needs flexibility in insurance coverage, premium deposits or investment returns, then universal life is the most appropriate product. This could be the case in business situations, changing family circumstances or clients in need of a non-registered tax-deferred investment product.

CASE STUDY ANALYSIS

Sunil (age 40) and Jasmine (age 35) are a married couple with two children, aged 10 and 8. Sunil works for a computer systems design corporation and earns a gross annual income of $80,000 a year. Jasmine works as an office administrator and earns about $18,000 a year. Investments provide another $2,000 a year of interest income.

The couple's assets and liabilities are presently as follows:

Assets	
House	$240,000
Cars (2)	$42,000
Short-term GIC	$35,000
RRSP (mutual funds)	$120,000
Group life insurance (Sunil)	$80,000
Liabilities	
Mortgage on house	$80,000
Car loans	$12,000
Commercial debt (credit cards, etc.)	$10,000
Final expense allowance (funeral, etc.)	$15,000
	($117,000)
Net Worth	$400,000

In the event of the death of either Sunil or Jasmine, they would like to see their debts paid off. Also, they feel that the survivor, with all debts paid, would be able to get along with an income equal to 60% of the current family income.

Sunil feels that he wouldn't need any additional financial support to assist the family should Jasmine die, but is concerned about her (and the children's) welfare if something were to happen to him. With his pensions (corporate and CPP), Sunil feels that Jasmine would be OK financially once she reaches retirement (age 60) and the kids were off on their own, but he remains worried

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about her for the intervening 25 years.

The first step in the insurance needs planning process is to determine what net current assets would be available to Jasmine, should Sunil die today. The liabilities are straight-forward: $117,000. Of the available $517,000 in assets, really only about $115,000 would be available immediately as cash at Sunil's death: the $35,000 in term deposits and the $80,000 of group life insurance proceeds. The house would be kept to live in, the cars (or at least one of them) would probably be kept to drive and the RRSP funds are earmarked for retirement – accessing them earlier would not be tax-efficient and would erode Jasmine's retirement assets, substituting a future problem for the purpose of solving a current one.

Thus, the current liabilities and the current liquid assets are basically a "wash," leaving the issue of income replacement to be dealt with.

The family income is currently as follows:

Sunil's salary	$80,000
Jasmine's salary	$18,000
Interest income	$2,000
Total	$100,000

If we accept Sunil's target of 60% of family income as being needed to support Jasmine and the children (this seems to be realistic), then she would require an annual income of $60,000 to support her until retirement should Sunil die prematurely.

$18,000 of this could come from Jasmine's own salary (assuming that she would continue working), leaving a shortfall of $42,000 a year. (Since the assets currently generating the interest income are not going to be available in the event of Sunil's death – they will be used to pay off debts – the $2,000 will not be a resource towards meeting the $42,000 shortfall. If the assets did not have to be liquidated, the $2,000 would continue after Sunil's death, reducing the shortfall to only $40,000.)

If we were to assume that Jasmine could invest her available capital at 5%, she would require an investment fund of $840,000 to generate $42,000 a year of interest income.

Of course, she could, alternatively, transfer her investment capital into a term certain annuity that would run from her age at Sunil's death until her retirement age of 60. This could substantially decrease the capital needed at death, but presupposes that an assumption could be made about when Sunil would die, so that the term of the annuity could be calculated. Minimally, the annuity would have to be assumed to run for 25 years (from today (at her age 35) until age 60), to guarantee full protection to Jasmine.

For the moment, we would recommend consideration be given to the purchase of a $840,000 term to 65 policy. The policy should also be convertible, to guarantee Sunil the right to convert the term coverage into permanent insurance should future insurance needs arise.

NOTE: For the sake of simplicity and focus, such capital and income items as the CPP death benefit and Survivor's benefits have been ignored in this illustration. Normally, they would also be factored into the equation (assuming that the client is comfortable relying on their continued viability). Also, no accommodation has been made to grow the survivor's income benefits to allow for the eroding effects of inflation. As we shall see in subsequent Units, these factors must also be taken into consideration.

Section summary

You should now be able to:

- Select the most appropriate individual life insurance products to match a client's situation and needs.

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STUDY UNIT SIX

FOREIGN ASPECTS OF CANADIAN ESTATE PLANNING

Knowledge Objectives

Skills Objectives

Topics Covered

6.1 INTRODUCTION 6-5

6.2 IMPACT OF FOREIGN LAWS ON CANADIAN ESTATES – OVERVIEW 6-5

6.2.1 Canadian Residents Who Own Foreign Property 6-6

6.2.2 Canadian Estate with a Non-Resident Beneficiary 6-7

6.2.3 Canadian Estate with a Non-Resident Executor 6-9

6.2.4 Foreign Trust Deemed Resident 6-9

6.2.5 Foreign Gifts or Inheritance Received by a Canadian 6-10

6.3 U.S. ESTATE AND GIFT TAX FOR CANADIANS – OVERVIEW 6-11

6.3.1 U.S. Citizens and U.S. Green Card Holders Living in Canada . 6-12

6.3.1.1 U.S. Income Tax – U.S. Citizens 6-12

6.3.1.2 U.S. Income Tax – U.S. Green Card Holders 6-13

6.3.1.3 U.S. Gift and Estate Tax – U.S. Citizens and Persons Domiciled in the U.S. (Resident Aliens) 6-14

6.3.2 Canadian Residents Who Spend Time in the U.S. or Own Property in the U.S. 6-17

6.3.2.1 U.S. Income Tax 6-17

6.3.2.2 U.S. Gift Tax 6-19

6.3.2.3 U.S. Estate Tax 6-20

6.3.3 The Canada-U.S. Treaty Applies Differently to U.S. Citizens Resident in Canada from Other Canadians 6-24

6.3.4 Different U.S. Estate Tax Rules for Canadians Who Are Not U.S. Citizens from Those Who Are 6-25

6.3.5 Different U.S. Gift Tax Rules for Canadians Who Are Not U.S. Citizens from Those Who Are 6-25

6.4 U.S. ESTATE TAX PLANNING FOR RESIDENTS OF CANADA WHO ARE NOT U.S. CITIZENS 6-26

6.4.1 Make Lifetime Gifts of U.S.-situs Property 6-27

6.4.2 Gift by Will of U.S.-situs Property to a U.S. Charity 6-27

6.4.3 Hold U.S. Securities in a Canadian Corporation. 6-27

6.4.4 Hold U.S. Investments through Canadian Mutual Funds 6-27

6.4.5 Taking Full Advantage of the Unified Credit as Between Husband and Wife. 6-28

6.4.6 Use Spousal Trusts in Both Wills of Husband and Wife 6-28

6.4.7 Use a Qualifying Domestic Trust (Q-DOT) for Assets Passing to a Surviving Spouse. 6-29

6.4.8 Life Insurance 6-29

6.5 SUMMARY OF KEY ISSUES 6-29

6.6 TERMINOLOGY 6-30

REVIEW QUESTIONS AND ANSWERS 6-32

APPENDIX 6.1 STEP Diploma Program, *Wills, Trust and Estate Administration*, Wendy D. Templeton, Chapter 14, Foreign Property, Multiple Jurisdictions and Succession . . . 6-39

Study Unit Six

Foreign Aspects of Canadian Estate Planning

Learning Objectives

Knowledge Objectives

Upon completion of this unit the student will:

- Understand how laws of other countries may apply to Canadian estates
- Understand how U.S. estate tax and U.S. gift tax can affect Canadians
- Understand key offshore planning concepts

Skills Objectives

Upon completion the student will, in relation to the topics listed below, be able to:

Offshore Planning Basics

- Explain the key offshore planning opportunities and the importance of specialized advice
- Describe the limitations of offshore planning
- Understand how laws of other jurisdictions may affect succession of property
- Recognize situations in which foreign succession law may apply to Canadian estates

U.S. Estate Tax Planning

- Identify potential exposure to U.S. estate and gift taxes for U.S. citizens resident in Canada
- Identify situations in which Canadians who are not U.S. citizens may be subject to U.S. estate and gift tax
- Identify the client's U.S. assets and discuss their effect on the client's wealth transfer and estate planning

- Describe the planning strategies that may reduce the cost of U.S. estate tax
- Explain the need for specialized expertise to advise on U.S. issues

Topics Covered

- Basics of Offshore Tax Planning
- Basics of Taxation of Foreign Trusts in Canada
- U.S. Estate Tax for Canadian Residents, including U.S. citizens, resident aliens, and non-resident aliens of the U.S.
- U.S. Gift Tax for Canadian Residents, including U.S. citizens, resident aliens, and non-resident aliens of the U.S.

6.1 INTRODUCTION

With an increasingly globalized world, it is much more common to find that a Canadian advisor, in preparing and implementing an estate plan for a Canadian resident, must also consider the application of the laws of another jurisdiction.

The purpose of this study unit is to ensure that financial advisors are able to identify situations where foreign laws may impact estate planning for Canadians. Most importantly, the advisor should be able to recognize those scenarios in which he or she should seek advice from another expert, usually a professional who regularly deals with the law of the other jurisdiction or a professional practising in that other jurisdiction.

This study unit does not include issues relating to non-residents of Canada. It is confined to a discussion of how residents of Canada may be affected by the tax and succession laws of foreign jurisdictions. In particular, we will focus on planning for U.S. citizens or U.S. green card holders who are subject to both U.S. and Canadian income tax on their world-wide income and generally are subject to U.S. gift and U.S. estate tax.

Because of the proximity of the U.S. to Canada and the regular travel and business dealings undertaken by Canadian individuals in the U.S., we will also discuss how U.S. laws can impact estate planning for Canadians.

6.2 IMPACT OF FOREIGN LAWS ON CANADIAN ESTATES – OVERVIEW

Advisors who provide financial planning for residents of Canada may need to consider foreign aspects of estate planning when dealing with individuals who:

- own property located in a foreign country,
- regularly spend time in a foreign country,
- are inheriting assets from a foreign country, or
- are leaving assets to non-resident beneficiaries.

These aspects are discussed in the first part of this Study Unit. If the Canadian resident is a citizen of another country, the estate planning may also be affected by the laws of that country. This will be illustrated in the latter part of the Study Unit, which focuses on U.S. tax issues as they relate to Canadian residents.

6.2.1 Canadian Residents Who Own Foreign Property

A Canadian taxpayer is deemed to dispose of all of his or her assets on death, and this deemed disposition may result in income and capital gains that are taxed at death. In addition, provincial probate fees may also apply. When a Canadian taxpayer owns a foreign property he or she should review whether provincial probate fees (based on where the taxpayer resides immediately prior to his or her death) will apply to the foreign property.

It is also prudent to inquire whether death tax, estate tax, inheritance tax, or other succession duties may be imposed on the death of the Canadian owner by the jurisdiction in which the foreign property is located. If such inheritance taxes and duties apply these are generally only imposed on immoveable property (including real estate, property used in a business, livestock and equipment used in agriculture and forestry, mineral deposits, resources, or other natural resources) that is situated in the foreign jurisdiction.

The STEP Yearbook contains summaries of income and inheritance taxes for many jurisdictions. Canada has entered into a large number of tax conventions or agreements (referred to as tax treaties) with other countries. Generally, the main purpose of a tax treaty is to prevent double taxation, prevent tax evasion, and encourage cross-border trade efficiencies. The treaties define what taxes are covered by the treaty, who is a resident, and who is eligible for the benefits of the treaty. The treaty will often work to reduce tax withheld from income paid from a resident in one country to a resident of the other country. Most, but not all, of the treaties are based on the Organisation for Economic Co-operation and Development (OECD) model that exempts capital gains on moveable property owned by a non-resident of a particular country.

If, on the passing of an immoveable property on death, capital gains tax is imposed by the foreign jurisdiction and a treaty exists between Canada and that jurisdiction, the taxpayer will generally be able to claim a foreign tax credit against Canadian taxes payable for foreign tax paid. The foreign tax credit may reduce or even eliminate the tax payable as a result of the deemed disposition that occurs on the death of the Canadian resident.

Determining whether any complications could arise, and managing those complications, may require a competent cross-border specialist with knowledge

of tax laws in both jurisdictions or a team of tax specialists who are able to coordinate their advice.

A Canadian Will may not be recognized in the foreign jurisdiction where the property is situated. The Canadian owner should ensure that the Canadian Will is reviewed by a lawyer licensed to practise in the jurisdiction where the property is located. The foreign lawyer may recommend that a separate Will is prepared in the other jurisdiction that deals with the property located in that jurisdiction. In that case, it is important that the Canadian lawyer reviews the foreign Will to ensure there is no conflict between the two Wills and that neither Will revokes the other.

6.2.2 Canadian Estate with a Non-Resident Beneficiary

When a Canadian estate makes a distribution of income to non-resident beneficiaries, that distribution may be subject to withholding tax. The general withholding tax rate is 25% but this amount may be reduced pursuant to a tax treaty between Canada and the country in which the non-resident beneficiary resides. The withheld tax must be submitted to the Canada Revenue Agency (CRA), and additional forms and slips may be required to be filed to report the income distributed and foreign tax withheld. The non-resident beneficiary would receive a copy of the non-resident slip and may be able to claim a foreign tax credit for the Canadian tax withheld in his or her country of residence. If the withholding tax is not withheld or remitted properly, the trustees of the estate can be held personally liable for the withholding tax and penalties may be applied.

While income retains its character when it is distributed from a Canadian estate to its Canadian beneficiaries, this is not always the case when the income is distributed to a non-resident beneficiary. So a dividend or capital gain distributed to a non-resident beneficiary may be taxed as ordinary income in the hands of the non-resident beneficiary.

When a Canadian estate makes a distribution of capital to its Canadian beneficiaries, that transfer can occur on a “rollover” basis, which means the beneficiary can receive capital with a cost base equal to that of the deceased’s estate (usually the fair market value of the property on death). This rollover is not available to non-resident beneficiaries. When a Canadian estate makes a partial or full distribution of capital to a non-resident beneficiary of the estate, the CRA has historically taken the position that the non-resident beneficiary is deemed to dispose of his or her interest in the estate. This interest was always considered to be “taxable Canadian

property" and the taxpayer was therefore required to file a Request for a Section 116 Compliance Certificate, obtain a compliance certificate, and file a T1 Return with the CRA to report the disposition. This caused quite a compliance burden when capital was distributed in the form of cash and no tax was payable (because the cost and the fair market value of the distribution is the same). In an effort to ease this burden, Budget 2010 amended the definition of "taxable Canadian property" and, effective 2009, a compliance certificate is no longer required when a trust makes a distribution, unless anytime within the prior 60 months most (meaning 50% or more) of the value of the trust interest is attributable to real property situated in Canada.

If more than half of the fair market value of the estate is attributable to real property located in Canada anytime in the preceding last 5 years, the following procedures must be followed.

1. The estate trustee or trustees must require that the non-resident obtain a compliance certificate from the CRA when distributions of capital are made.
2. The T2062 Request for a Section 116 Compliance Certificate can be filed in advance of the distribution and must be filed within 10 days after the distribution. A separate request must be filed for each distribution (partial or full).
3. Where income is distributed, 25% of the income allocated must be withheld and remitted to the CRA with the request; where property is distributed, 25% of the estimated capital gain must be withheld and remitted to the CRA. Where only cash is distributed, the cost and fair market value are equal, which means that no withholding tax has to be remitted with the request.

If a request is not filed, the estate trustees may be personally liable for failure to deduct and remit the 25% withholding tax (the amount withheld may be reduced as a result of the treaty between Canada and the country in which the non-resident beneficiary resides) and for the tax payable by a non-resident beneficiary in respect of distributions of taxable Canadian property.

6.2.3 Canadian Estate with a Non-Resident Executor

Most advisors will recommend that a non-resident executor not be selected because it can cause a myriad of complications. One practical reason is that it is difficult to administer the Canadian estate from abroad. Having a non-resident executor may also create a question as to whether the estate is considered a resident of Canada because the executor of the estate is a non-resident of Canada.

When a Canadian resident passes away, the estate is considered a trust. The executors are trustees. The residency of a trust is a question of fact. There have been no statutory rules or criteria that have been set out to determine the residency of a trust. The Canadian courts have determined the residency of a trust and traditionally looked to the residency of the executors to determine if an estate is taxable in Canada. In situations involving an even number of trustees residing inside and outside of Canada, the courts traditionally looked to the location of the estate assets and the jurisdiction where the legal rights with respect to those assets were enforceable.

More recently, the courts have indicated that the residency of a trust should be determined in the same way that residency is determined for corporations. That is to say that the trust will be considered resident where the central management and control of the trust abides.

This means if a Canadian resident has selected a non-resident executor, then the estate may also be considered non-resident. Similarly, if a Canadian executor makes all of the decisions and has oversight responsibility for the estate of a foreign person, that estate may be considered a resident of Canada and subject to tax in Canada.

6.2.4 Foreign Trust Deemed Resident

A non-resident trust may be subject to tax in Canada under special provisions in the *Income Tax Act* that are designed to ensure that income earned indirectly by Canadian taxpayers through foreign intermediaries is not taxed at a more favourable rate than would be the case were the income earned without the involvement of those intermediaries. These complex rules are known as the Foreign Investment Entity (FIE) Rules, which were proposed with a retroactive effective date and, since that time, these rules have been subject to many revisions.

The FIE rules ensure that a non-resident trust is subject to Canadian tax on its worldwide income if there is a resident beneficiary of the trust or a resident contributor to the trust. In order for there to be a resident beneficiary, there must be a beneficiary resident in Canada and there must be a connected contributor who was a resident in Canada within 5 years (before or after) of the time of contribution. A resident contributor is an individual who has transferred or loaned property to a trust and who is a resident of Canada.

The rules are broad and can encompass many innocent estate-planning transactions that involve non-resident trusts. It is prudent to obtain expert tax advice when dealing with offshore trusts.

Canadian taxpayers who loan, transfer, or contribute funds to a non-resident trust must file Form T1141 Information Return in Respect of Transfers or Loans to a Non-Resident Trust to report such transactions. Significant penalties may be applied if this information form is filed late, filed incorrectly, or not filed.

6.2.5 Foreign Gifts or Inheritance Received by a Canadian

Generally, an inheritance received by a beneficiary in most countries can be received without being subject to gift tax or inheritance tax. It is more practical to tax the person who makes the gift or the estate of the deceased.

Receiving an inheritance from a foreign country is not subject to Canadian tax if the funds are coming from an estate as capital. The beneficiary's cost base for Canadian tax purposes is set at the fair market value at the time the cash or assets are received from the estate. Any income/capital gains or losses realized after that time will be subject to tax in Canada.

If the Canadian beneficiary receives certain foreign property with a cost base in excess of $100,000CAD or, as a result of the inheritance, now owns certain foreign property with an aggregate cost in excess of $100,000CAD, then the beneficiary would be required to file a T1135 Foreign Income Verification Statement annually. Significant penalties may be applied if this information form is filed late, filed incorrectly, or not filed. These penalties may be levied even if all foreign income received from the foreign property was fully declared on the beneficiary's tax return.

If a Canadian beneficiary receives a distribution or loan from a non-resident (or foreign) trust, the beneficiary may be required to complete the T1142 Information Return in respect of distributions from or indebtedness to a non-resident trust. Significant penalties may be applied if this information form is filed late, filed incorrectly, or not filed. There is an exception for distributions received from an estate that arose on and as a consequence of death; therefore, it is important to distinguish from whom the inheritance is received. Inheritances may not always be received from an estate; sometimes inheritances are received from a non-resident testamentary trust, in which case the T1142 may be required to be filed.

6.3 U.S. ESTATE AND GIFT TAX FOR CANADIANS – OVERVIEW

Whenever the laws of a foreign country are examined with respect to their effect on a Canadian individual, caution must be exercised. This is particularly true with respect to the U.S. estate and gift tax rules. It is important to recognize where U.S. issues arise, and when to refer the client to professionals who have expertise in cross-border Canada-U.S. planning. Often a team is necessary with both Canadian and U.S. experts, each of whom have knowledge and experience in dealing with cross-border planning, the laws of both Canada and the U.S., and the effect of the Canada-U.S. Tax Treaty on both.

There is much confusion relating to these U.S. rules as information available in the media and written by experts often does not distinguish or define clearly to whom the information could apply. For example, the rules apply very differently depending into which of the following categories any particular individual may fall:

- U.S. citizens who reside in the U.S.,
- U.S. citizens who reside in Canada,
- U.S. Green Card holders who are domiciled in the U.S., or
- Canadian residents who are non-resident aliens of the U.S.

Whenever a person who resides in Canada is a U.S. citizen or U.S. Green Card holder, owns property in the U.S., or spends a lot of time in the U.S., advisors should exercise caution. Planning for such individuals is very complex and necessitates the involvement of a U.S. tax professional to avoid costly mistakes.

6.3.1 U.S. Citizens and U.S. Green Card Holders Living in Canada

6.3.1.1 U.S. Income Tax – U.S. Citizens

Unlike Canada and most other countries worldwide, the U.S. taxes its citizens on their worldwide income wherever they reside. U.S. citizens living in Canada are required to file an annual U.S. tax return to report their worldwide income, including their Canadian source income. As a resident of Canada, U.S. citizens living in Canada also have to file an annual tax return with the CRA reporting their worldwide income.

Where an individual is subject to income tax in both Canada and the U.S., the double tax that could result is generally managed through the provisions of the Canada-U.S. Tax Treaty. The treaty in certain circumstances allows for a foreign tax credit to be claimed that offsets the tax payable in one country for tax paid in the other country. The country where the income is sourced is entitled to collect tax first.

Consider, for example, a U.S. citizen who lives in Canada but who earns pension income in the U.S. of $50,000USD and who is subject to tax on that income at 35% in the U.S. Let's assume for illustrative purposes that $1.25CAD = $1.00USD. In Canada, the $62,500CAD is included in income and subject to tax at 40%. The individual would be able to claim a $21,875CAD foreign tax credit for U.S. tax paid to offset the $25,000CAD tax payable. The balance payable to the CRA in this case would be $3,125CAD.

If the U.S. citizen lives outside of the U.S. and has a *bona fide* residence in that country, he or she may also be able to claim a foreign-earned income exclusion of non-U.S. source income on his or her U.S. return. If the foreign-earned income exclusion is claimed, the U.S. taxpayer is prevented from also being able to claim a foreign tax credit for the U.S. tax paid on such income. The table in Figure 6.1 contains the foreign-earned income exclusion amount, which is indexed on an annual basis.

Figure 6.1: Foreign-earned Income Exclusion

YEAR	FOREIGN-EARNED INCOME EXCLUSION AMOUNT ($USD)
2019	TBD*
2018	$104,100
2017	$102,100
2016	$101,300

*The inflation adjusted exclusion amount for 2019 will be announced by the IRS in October 2018.

In this manner, double tax can generally be mitigated or eliminated, but the individual will ultimately find that he or she is subject to the higher rate of tax between the jurisdictions.

6.3.1.2 U.S. Income Tax – U.S. Green Card Holders

A U.S. Green Card holder is a resident alien for U.S. tax purposes and is required to file a U.S. tax return annually to report his or her worldwide income. A U.S. Green Card holder will continue to be considered a U.S. resident unless the U.S. Green Card holder has received an official notice from the U.S. Citizenship and Immigration Service that there has been a final administrative or judicial determination that his or her Green Card has been revoked or abandoned. Where a Green Card has expired, additional steps will need to be taken to relinquish or abandon the Green Card.

There are a number of ways that a U.S. Green Card holder who is subject to tax both in Canada (as a resident) and the U.S. (as a resident alien) may be able to mitigate his or her exposure to double tax. Like U.S. citizens, Green Card holders may be able to claim foreign tax credits or the foreign-earned income exclusion.

A U.S. Green Card holder with closer residential ties to Canada may also be able to claim a treaty exemption under the tie-breaker rules found under the Canada-U.S. Tax Treaty. The tie-breaker rules look at the taxpayer's centre of vital interest and personal and economic ties. If the taxpayer's centre of vital interests is in Canada, he or she will be deemed to be a resident of Canada and a non-resident alien of the U.S.

However, claiming a treaty exemption may have a number of unintended tax consequences.

- The U.S. Green Card holder terminates his or her U.S. residency status for federal income tax purposes and may be subject to expatriation tax.
- The U.S. Green Card holder continues to be considered a U.S. resident for purposes other than determining the U.S. income tax liability and will therefore still be subject to the annual reporting obligations as a U.S. resident.
- The U.S. Green Card holder may be prevented from renewing his or her Green Card or applying for U.S. citizenship.

6.3.1.3 U.S. Gift and Estate Tax – U.S. Citizens and Persons Domiciled in the U.S. (Resident Aliens)

In addition to being taxed on their worldwide income in the U.S. regardless of where they reside, U.S. citizens or U.S. Green Card holders domiciled in the U.S. are subject to gift and estate tax on their worldwide assets (not just their U.S.-situs property).

Please note that the concept of domicile for estate tax purposes is not the same as the concept of residence used for income tax purposes. The analysis of whether a person is domiciled in the U.S. looks at the following factors: duration of stay in the U.S. and other countries; the frequency of travel between the U.S. and other countries, as well as between locations abroad; the size, cost, and nature of dwelling places and whether these are rented out or owned; the location of valuable possessions, family, and close friends; church and club memberships; and, business interests. Where a U.S. Green Card holder establishes a domicile in Canada and intends to remain in Canada indefinitely, the U.S. Green Card holder may be considered to not have domicile in the U.S. and would not be subject to U.S. gift and estate tax.

U.S. gift and estate tax are integrated. Gift tax is levied on the transfer of property to another taxpayer for no consideration or less than fair market value consideration during one’s lifetime. Estate tax is levied on

the fair market value of the worldwide estate when a U.S. citizen (no matter where they reside) or person domiciled in the U.S. dies. The maximum rate of gift and estate tax is 40% on lifetime gifts or taxable estates in excess of $1 million.

The computation of the gift and estate tax for U.S. citizens, those domiciled in the U.S. (resident aliens), and non-resident aliens uses the same table (see Figure 6.2), but the availability of tax credits to offset the tax calculated is not necessarily the same.

Figure 6.2: Gift and Estate Tax for U.S. Citizens

TAXABLE ESTATE	TENTATIVE FEDERAL TAX
Less than $10,000	18% of such amount
$10,000–$20,000	$1,800 + 20% of excess over $10,000
$20,000–$40,000	$3,800 + 22% of excess over $20,000
$40,000–$60,000	$8,200 + 24% of excess over $40,000
$60,000–$80,000	$13,000 + 26% of excess over $60,000
$80,000–$100,000	$18,200 + 28% of excess over $80,000
$100,000–$150,000	$23,800 + 30% of excess over $100,000
$150,000–$250,000	$38,800 + 32% of excess over $150,000
$250,000–$500,000	$70,800 + 34% of excess over $250,000
$500,000–$750,000	$155,800 + 37% of excess over $500,000
$750,000–$1,000,000	$248,300 + 39% of excess over $750,000
Over $1,000,000	$345,800 + 40% of excess over $1,000,000

For a U.S. citizen or resident alien, the lifetime gift and estate tax exclusion amounts for purposes of determining estate and gift tax are also integrated. The lifetime gift and estate tax exclusion amount is used to calculate the unified estate tax credit, which offsets the amount of U.S. estate tax payable on an estate with a worldwide value equal to or less than the lifetime gift and estate tax exemption amount. The table in Figure 6.3 sets out the lifetime gift and estate tax exclusion amount for a U.S. citizen or resident alien.

Figure 6.3: Lifetime Gift and Estate Tax Exclusion Amount for a U.S. Citizen or Resident Alien

YEAR	LIFETIME GIFT AND ESTATE TAX EXCLUSION AMOUNT (USD)	UNIFIED ESTATE TAX CREDIT (USD)
2019	TBD*	TBD*
2018	$5,600,000	$2,185,800**
2017	$5,490,000	$2,141,800
2016	$5,450,000	$2,125,800
2015	$5,430,000	$2,117,800
2014	$5,340,000	$2,081,800

*The inflation adjusted exclusion amount for 2019 will be announced by the IRS in October 2018.

**$2,185,800 is the 2018 U.S. estate tax payable on $5,600,000 of assets.

Significant changes were made to gift and estate tax under the *American Taxpayer Relief Act of 2012*. For 2013 and subsequent years, when both spouses are U.S. citizens, any lifetime gift and estate tax exclusion amount not fully utilized by one spouse can be carried over and used by the surviving spouse. As a result, when both spouses are U.S. citizens, the lifetime gift and estate tax exclusion amount of each spouse can effectively be combined (for example, $11,200,000 if both deaths occurred in 2018).

President Trump has indicated that he intends to repeal the U.S. estate tax and to replace the U.S. estate tax regime with a deemed disposition rule at death thereby triggering any unrealized gains or losses on death.

U.S. citizens and resident aliens are required to track their annual gifts. In addition to the lifetime gift and estate tax exclusion amount noted above, there is an unlimited exclusion for gifts made to a spouse who is also a U.S. citizen, an annual exclusion amount for gifts made to a spouse who is not a U.S. citizen, and an annual exclusion amount for gifts made to persons other than a spouse (children, for example). The annual gift tax exclusion amount is determined per recipient, which means that annual gifts to any number of individual recipients may be made without having gift tax apply. Gifts made within the annual gift

tax exclusion amount do not reduce the U.S. citizen or resident alien's lifetime gift and estate tax exclusion amount. Figure 6.4 contains the annual gift tax exclusion amounts.

Figure 6.4: Annual Gift Tax Exclusion Amounts

YEAR	ANNUAL EXCLUSION AMOUNT FOR GIFTS TO A SPOUSE WHO IS A U.S. CITIZEN	ANNUAL EXCLUSION AMOUNT FOR GIFTS TO A SPOUSE WHO IS NOT A U.S. CITIZEN ($USD)	ANNUAL EXCLUSION AMOUNT FOR GIFTS TO OTHERS ($USD)
2019	TBD*	TBD*	TBD*
2018	Unlimited	$152,000	$15,000
2017	Unlimited	$149,000	$14,000
2016	Unlimited	$148,000	$14,000
2015	Unlimited	$147,000	$14,000
2014	Unlimited	$145,000	$14,000
2013	Unlimited	$143,000	$14,000

*The inflation adjusted exclusion amounts for 2019 will be announced by the IRS in October 2018.

Generally speaking, a U.S. citizen or resident alien who makes gifts in excess of the annual exclusion amounts is required to file a gift tax return.

The U.S. also imposes a generation-skipping transfer tax, which effectively doubles the gift tax exposure when a gift bypasses the next generation for a later generation. This could apply, for example, when a grandparent makes a gift to a grandchild.

6.3.2 Canadian Residents Who Spend Time in the U.S. or Own Property in the U.S.

6.3.2.1 U.S. Income Tax

A person who is not a U.S. citizen or a U.S. Green Card holder may still be subject to U.S. taxation on worldwide income if he or she has a "substantial presence" in the U.S.

The substantial presence test determines residency based on the number of days the individual was present in the U.S. on a rolling 3-year formula.

For the purpose of the substantial presence test, each partial day of presence is counted as a full day in calculating days spent in the U.S.

An individual will be considered to have a substantial presence in the U.S. and to be a U.S. resident for tax purposes if the individual was physically present in the United States for:

- 31 days during the current year, and
- ≥ 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting:
    - all the days you were present in the current year, and
    - 1/3 of the days you were present in the first year before the current year, and
    - 1/6 of the days you were present in the second year before the current year.

There are a number of ways that an individual who has a substantial presence in the U.S. may be able to mitigate his or her exposure to double tax. The individual may be able to claim foreign tax credits, the foreign-earned income exclusion, or the treaty exemption (discussed above as it relates to U.S. Green Card holders). In addition to these mechanisms, the individual may also be able to claim a closer connection exception (which is not available to U.S. citizens or U.S. Green Card holders) by filing Form 8840. By filing this form, the individual protects his or her ability to claim a closer connection to Canada and indicates that he or she should not be filing a U.S. return as a U.S. resident. If this form is not filed or is filed late, the individual loses his or her ability to claim the closer connection exception and may be treated as a U.S. resident who is subject to tax on his or her worldwide income.

An individual can avoid being treated as a U.S. resident when he or she has a closer connection to another country, if:

- the individual was present in the United States for fewer than 183 days in the current year,
- the individual can establish that he or she had a "tax home" in a foreign country, and

- the individual can establish that he or she had a closer connection to one foreign country in which he or she had a "tax home" than to the United States.

A "tax home" is an individual's main place of business, employment, or post of duty regardless of where the individual maintains his or her family home. If an individual does not have a regular or main place of business because of the nature of his or her work, then the individual's "tax home" is the place where he or she regularly lives.

6.3.2.2 U.S. Gift Tax

Canadian residents who are not U.S. citizens or domiciled in the U.S. are considered non-resident aliens for gift tax purposes and are subject to U.S. gift tax only on gifts of their interest in real or tangible property (includes U.S. real estate and tangible personal property such as automobiles, boats, etc.) situated in the U.S. Generally, gifts of intangible property (like U.S. stock) made by a non-resident alien, regardless of the location of the property, are not subject to gift tax.

Like citizens and residents, a non-resident alien donor may claim an annual gift tax exclusion amount for a gift made to a spouse who is not a U.S. citizen or to other individuals. Gift tax will not apply to gifts made to a spouse who is a U.S. citizen. The lifetime gift and estate tax exclusion amount that is available to U.S. citizens and residents is not available to non-resident aliens for gift tax purposes.

The Canada-U.S. Tax Treaty does not cover gift tax, which means that a foreign tax credit to offset Canadian tax payable on the disposition of a property that is gifted cannot be claimed for U.S. gift tax paid. The gift may still result in a deemed disposition at fair market value for Canadian tax purposes and any unrealized gains would be triggered, but the tax payable cannot be offset by claiming a foreign tax credit for the U.S. gift tax. Generally speaking, Canadian residents who are not U.S. citizens or resident aliens should not make a significant lifetime gift of U.S. tangible property.

6.3.2.3 U.S. Estate Tax

Canadian residents who are not U.S. citizens or domiciled in the U.S. are considered non-resident aliens for estate tax purposes and are subject to estate tax to the extent that they own U.S.-situs property on death.

For a Canadian resident who is not a U.S. citizen or resident alien, U.S.-situs property includes:

- U.S. real estate (real property including real estate and time shares);
- tangible property located in the U.S., including household goods, automobiles, furnishings;
- U.S. securities, including those held in a brokerage account in Canada or outside of Canada;
- U.S. mutual funds, including money market funds;
- U.S. pension plans;
- interests in certain trusts, including RRSPs, RRIFs, RESPs, or TFSAs; and
- any business-related assets owned and used in the U.S.

For a non-resident alien, the following categories of assets are not included in U.S.-situs property and are not subject to U.S. estate tax:

- Canadian mutual funds investing in U.S. equities;
- U.S. bank accounts and term deposits (unless connected with a U.S. business);
- publicly traded U.S. bonds and U.S. Treasury Bills; and
- life insurance proceeds where the policy owner/life insured is neither a resident nor a citizen of the U.S.

The value of any non-recourse debt (an obligation that is only enforceable against the property pledged as security) can be deducted from the value of U.S. property in determining the client's exposure to U.S. estate tax.

The Canada-U.S. Tax Treaty (Article XXIX-B.2) provides a number of mechanisms for a Canadian resident who is not a U.S. citizen or resident alien to mitigate exposure to U.S. estate tax including:

1) The Unified Estate Tax Credit

Pursuant to the treaty, a Canadian resident who is a non-resident alien of the U.S. is able to claim a pro-rated portion of the unified estate tax credit available to U.S. citizens or resident aliens.

The unified estate tax credit available for a non-resident alien is equal to the greater of:

- $13,000 or
- $$\frac{\text{Value (\$USD) of gross estate situated in the U.S}}{\text{Value (\$USD) of total worldwide gross estate}} \ast \text{Unified Estate Tax Credit}$$

In 2018, the full unified estate tax credit is $2,185,800.

Under the Canada-U.S. Tax Treaty, a Canadian resident who is not a U.S. citizen or resident alien will have an exclusion amount equal to the greater of $60,000 and a pro-rated portion of the unified estate credit available to a U.S. citizen, determined by dividing the individual's gross estate situated in the U.S. by the individual's gross estate wherever situated in the world. The application of the unified estate tax credit determines the portion of the estate excluded from U.S. estate tax.

Under this formula, a Canadian resident who is not a U.S. citizen or resident alien should not have U.S. estate tax exposure if:

- at the time of death, the value of the U.S.-situs property did not exceed $60,000USD and
- at the time of death, their worldwide estate has a value less than the lifetime gift and estate tax exclusion amount for that year.

The executor must file a U.S. Estate Tax Return for Non-Residents if at the date of death the value of the deceased's U.S.-situs property located in the United States exceeds $60,000USD. This return must be filed even

if no estate tax is payable. The return must be filed within 9 months of the date of death. The executor may become personally liable for a failure to pay U.S. estate tax.

> Example 1:
>
> Jane is a single Canadian resident who is not a U.S. taxpayer. Jane dies in 2018. At the time of death, the value of her gross estate situated in the U.S. was $1 millionUSD, and the value of her total worldwide gross estate was $5 millionUSD. Thus, her exclusion amount = $1 million/$5 million * $2,185,800 = $437,160. As the exclusion amount is greater than the estate tax of $345,800 that would be charged on her gross estate (estate tax on U.S.-situs assets of $1 million) situated in the U.S., the estate should not have any U.S. estate tax exposure, although the executor will still need to file a U.S. Estate Tax Return within 9 months after the date of death because the value of the U.S. situs property is in excess of $60,000USD.

> Example 2:
>
> Mike is a single Canadian resident who is not a U.S. taxpayer. Mike dies in 2017. At the time of death, the value of his gross estate situated in the U.S. was $1.5 millionUSD, and the value of his total worldwide gross estate was $6.5 millionUSD.
>
> | | | |
> |---|---|---|
> | Estate tax on first $1,000,000 | = | $345,800 |
> | Estate tax on next $500,000 x 40% | = | $200,000 |
> | | | $545,800 |
>
> As a non-resident alien, Mike can claim a pro-rated unified credit, which is calculated as follows:
>
> $1,500,000 / $6,500,000 x $2,141,800 (2017 amount) = $494,262
>
> Thus, Mike's estate will be subject to net U.S. estate tax on his death = $545,800 – $494,262= $51,538USD. Mike's executor will need to file a U.S. Estate Tax Return.

2) The Marital Estate Tax Credit

Another relieving provision found under the Canada-U.S. Tax Treaty is the non-refundable additional marital credit when assets are transferred to a surviving Canadian spouse. The additional marital credit equals the lesser of the unified estate tax credit and the amount of the estate tax otherwise payable. An unlimited marital deduction is available for assets transferred to a U.S. resident spouse.

3) The Foreign Tax Credit

The Canada-U.S. Tax Treaty provides some relief from U.S. estate tax in that the U.S. estate tax paid on death may be eligible as a foreign tax credit that offsets Canadian taxes payable in the year of death. On death, a Canadian resident will pay tax on the accrued gain of a U.S. asset because of the deemed disposition that takes place at death for Canadian tax purposes. The Canadian resident may also be subject to U.S. estate tax. Because U.S. estate tax rates are higher than the Canadian rates on capital gains, it may be possible to offset all of the Canadian tax payable by claiming a foreign tax credit. Ultimately, the individual will pay tax at the higher rate between the two jurisdictions.

4) Relief for Small Estates

The Canada-U.S. Tax Treaty provides some relief from U.S. estate tax for small estates worth less than $1.2 millionUSD. This relief will not apply when the Canadian taxpayer's estate includes U.S. real property or an interest in a U.S. partnership or U.S. corporation that holds real property in the U.S.

5) Donating U.S. Situs Property to a U.S. Charity

If the U.S. situs property is donated to a U.S. charity, the U.S. estate tax on the asset will be avoided.

It is important to note that in order to claim the benefits of the Canada-U.S. tax treaty, a U.S. estate tax return must be filed on behalf of the deceased. Even if the estate will have no U.S. estate tax liability it is therefore very important that the return is filed.

6.3.3 The Canada-U.S. Treaty Applies Differently to U.S. Citizens Resident in Canada from Other Canadians

Canadian residents who are not U.S. citizens may benefit from the relieving provisions of the tax treaty between Canada and the U.S., whereas U.S. citizens who live in Canada may not benefit in all cases, as the treaty applies to them quite differently. Generally, U.S. citizens living in Canada benefit from the treaty relief as it relates to Canadian tax, but not as it relates to U.S. tax.

For example, U.S. citizens are not entitled to the pro-rated unified estate tax credit under the Canada-U.S. Tax Treaty because they are already entitled, under U.S. domestic law, to 100% of the unified credit without any reduction.

In addition, it is generally accepted that U.S. citizens living in Canada are not entitled to the marital credit under the treaty because they are entitled to the U.S. marital deduction under U.S. domestic law — and this deduction is not available to other Canadians unless the property is transferring to a spouse who is a U.S. citizen. The marital deduction is available under U.S. domestic law for the first to die of a married couple where both are U.S. citizens or other persons taxed as U.S. citizens such as Green Card holders. It defers the U.S. estate tax on any amount left to the surviving spouse or certain spousal trusts, until the death of the surviving spouse. Canadians who are non-resident aliens for U.S. tax purposes may only benefit from the unlimited marital deduction if the property is left for the benefit of the surviving spouse in a qualifying U.S. domestic trust (Q-DOT) and no marital credit relief is claimed.

Figure 6.5: Marital Credit Availability: Under Canada/U.S. Treaty

IS DECEASED A U.S. CITIZEN?	SURVIVING SPOUSE	SURVIVING SPOUSE
	U.S. Citizen	**Not a U.S. Citizen**
YES	NO; as the unlimited marital deduction is provided for under U.S. Domestic Law	YES, can elect to claim marital credit in addition to the unified credit
NO	NO; as the unlimited marital deduction is provided for under U.S. Domestic Law	YES, can elect to claim marital credit in addition to the *pro-rata* unified credit

Figure 6.6: Unlimited Marital Deduction Availability: Under U.S. Domestic Law

IS DECEASED A U.S. CITIZEN?	SURVIVING SPOUSE	SURVIVING SPOUSE
	U.S. Citizen	**Not a U.S. Citizen**
YES	YES; Q-DOT not required	NO; unless waive marital credit under the Canada/U.S. Treaty and use Q-DOT
NO	YES; Q-DOT not required	NO; unless waive marital credit under the Canada/U.S. Treaty and use Q-DOT

6.3.4 Different U.S. Estate Tax Rules for Canadians Who Are Not U.S. Citizens from Those Who Are

Many of the U.S. rules that apply to U.S. citizens resident in Canada do not apply to Canadians who are non-resident aliens.

For example, under the new rules introduced in 2010, the unused unified estate tax credit on the death of the first spouse is "portable" to the estate of the last spouse to die in certain circumstances. This benefit is not available to non-resident aliens.

6.3.5 Different U.S. Gift Tax Rules for Canadians Who Are Not U.S. Citizens from Those Who Are

U.S. gift tax differs for Canadians depending on whether they are U.S. citizens or not, and whether they are married to another Canadian who is a U.S. citizen or a non-resident alien of the U.S.

For example, a U.S. citizen wherever resident may use his or her unified estate tax credit during his or her lifetime to shelter annual gifts made in excess of the annual gift tax exclusion amount from U.S. gift tax, but this is not available for Canadian non-resident aliens.

Similarly, a U.S. citizen may make unlimited gifts to a U.S. spouse without attracting U.S. gift tax unless the recipient spouse is an non-resident alien of the U.S., in which case gifts of any property (whether U.S.-situs or not) exceeding the annual gift tax exclusion amount for spouses will be taxable unless the unified estate tax credit is available. On the other hand, gifts from one non-resident alien of the

U.S. to another are only potentially subject to U.S. gift tax if the gifted property is U.S.-situs property.

U.S. citizens are subject to U.S. gift tax on gifts made during their lifetime regardless of where the assets are located. Canadians who are not U.S. taxpayers are only subject to U.S. gift tax on U.S. situs property. "U.S. situs property" subject to gift tax differs from "U.S. situs property" for the purposes of U.S. estate tax in that intangible property is excluded for gift tax. This means, for example, that U.S. stocks and bonds are not subject to U.S. gift tax.

Figure 6.7: U.S. Gift Tax

IS DONOR A	RECIPIENT SPOUSE	RECIPIENT SPOUSE	RECIPIENT OTHER	RECIPIENT OTHER
U.S. CITIZEN?	**U.S. Citizen**	**Not a U.S. Citizen**	**U.S. Citizen**	**Not a U.S. Citizen**
YES	NO GIFT TAX: unlimited gift tax marital deduction available	YES: On gifts of all property exceeding the annual exclusion ($152,000 for 2018). May apply Unified Estate Tax Credit.	YES: On gifts of all property exceeding the annual exclusion ($15,000 in 2018). May apply Unified Estate Tax Credit.	YES: On gifts of all property exceeding the annual exclusion ($15,000 in 2018). May apply Unified Estate Tax Credit.
NO	NO GIFT TAX: unlimited gift tax marital deduction available	YES: Only on U.S. real and tangible personal property exceeding the annual limitation ($152,000 in 2018). No Unified Estate Tax Credit available.	YES: Only on U.S. real and tangible personal property exceeding the annual limitation ($15,000 in 2018). No Unified Estate Tax Credit available.	YES: Only on U.S. real and tangible personal property exceeding the annual limitation ($15,000 in 2018). No Unified Estate Tax Credit available.

6.4 U.S. ESTATE TAX PLANNING FOR RESIDENTS OF CANADA WHO ARE NOT U.S. CITIZENS

A number of strategies are available to reduce U.S. estate tax for residents of Canada. A U.S. professional should be consulted regarding any tax planning strategies to reduce U.S. estate tax. The U.S. gift tax rules, Canadian and U.S. income tax rules, the effect of the Canada-U.S. Tax Treaty, and the estate-planning

objectives of the taxpayer must all be considered before commencing any U.S. estate planning implementation. This typically requires input from both U.S. and Canadian advisors, ideally all of whom specialize in cross-border planning.

There are also planning techniques available to U.S. citizens who are resident in Canada. However, these are not specifically included in this material.

6.4.1 Make Lifetime Gifts of U.S.-situs Property

If the value of U.S.-situs property is reduced, so is the U.S. estate tax liability. Gifts of U.S.-situs property may be made annually to any recipient with a value not exceeding the annual gift tax Exclusion Amount (in 2018 $15,000USD for a gift to another person or $152,000USD for a gift to a non-U.S. spouse). Over time a substantial reduction of U.S.-situs property can be made in this manner as the limit is *per recipient* and both a husband and wife may make such gifts (i.e., $30,000USD can be given by a couple to each recipient in 2018). Keep in mind that property gifted to a spouse may be subject to U.S. estate tax on the death of the spouse.

6.4.2 Gift by Will of U.S.-situs Property to a U.S. Charity

U.S.-situs property donated on death to a U.S. charity will be deducted from both the U.S.-situs property and the U.S. taxable estate.

6.4.3 Hold U.S. Securities in a Canadian Corporation

The shares of a Canadian corporation holding U.S. securities will not be considered U.S.-situs property. Caution should be exercised if an existing U.S. portfolio is transferred into a Canadian corporation for the sole purpose of U.S. estate tax avoidance, as a U.S. anti-avoidance rule may apply.

6.4.4 Hold U.S. Investments through Canadian Mutual Funds

Generally Canadian mutual funds will not be considered U.S.-situs property even if the fund invests in U.S. securities.

6.4.5 Taking Full Advantage of the Unified Credit as Between Husband and Wife

Canadian individuals are entitled to a portion of the unified estate tax credit. Where possible a husband and wife can hold property to maximize the use of the available credit on the death of each spouse. This, combined with the use of spousal trusts (see below at 6.4.6), can significantly reduce the exposure to U.S. estate tax of a married couple. Note that special rules apply to property that is jointly held with a right to survivorship. Generally, for U.S. estate tax planning purposes, it is better not to hold property jointly with a right of survivorship because the full value of the property will still be subject to U.S. estate tax unless evidence is provided that the survivor paid for his or her share of the jointly held asset with his or her own funds. Transferring U.S.-situs property from one spouse to another to implement this strategy may attract U.S. gift tax (except for intangible U.S.-situs property), or could result in a mismatch later between the U.S. tax payable and Canadian tax payable as a result of the attribution rules. On the sale of the property or on death, U.S. tax will be a liability of the owner (the recipient), whereas Canadian tax will be a liability of the other spouse (the original owner). As a result, there is a mismatch and no foreign tax credit will be available to offset the Canadian tax payable on the gain.

6.4.6 Use Spousal Trusts in Both Wills of Husband and Wife

The use of "criss-cross" spousal trusts in both Wills of a husband and wife, where each provides a spousal trust for the benefit of the surviving spouse, may reduce the potential U.S. estate tax on the death of the surviving spouse although these must be properly structured to achieve the U.S. objectives. In addition, such trusts are usually designed to benefit from the spousal rollover under Canadian rules. The spousal trust can reduce the U.S. taxable estate of the surviving spouse because assets in the spousal trust are not included in the surviving spouse's estate for U.S. estate tax purposes. U.S. investments could be used to fund such a trust and this would have the result of significantly reducing U.S. estate tax on the death of the survivor. A restriction on discretion to distribute capital, other than realized capital gains, from the trust to the surviving spouse may be necessary in order to ensure the trust assets are excluded from the estate of the surviving spouse for U.S. purposes. In some cases, the right to encroach on capital must be subject to what are referred to as "hems" purposes. "Hems" stands for health,

education, maintenance, and support. The U.S. rules are very strict in this area, and U.S. counsel must review the Wills.

In order to use this strategy, assets must be held separately as between husband and wife (and not jointly with a right of survivorship) so they will form part of the estate of the first to die. The trust can be a qualifying spousal trust for Canadian tax purposes so that the rollover is available if during lifetime of the surviving spouse all net income is payable to the surviving spouse and no one other than the surviving spouse is entitled to the capital of the trust.

6.4.7 Use a Qualifying Domestic Trust (Q-DOT) for Assets Passing to a Surviving Spouse

Where assets are bequeathed to a Q-DOT, a non-resident alien of the U.S. can use the marital deduction in lieu of the marital credit to eliminate U.S. estate tax on assets passing to the Q-DOT on the first death. However, this strategy results in a tax deferral rather than a tax saving as all assets in the trust will be taxed either on distribution during the lifetime of the surviving spouse or on the death of the surviving spouse. U.S. rules set out the terms for a spousal trust to qualify as a Q-DOT. Among other requirements, the trust must have a U.S. trustee.

6.4.8 Life Insurance

Life insurance can be used to fund the U.S. estate tax liability in appropriate circumstances. Life insurance issued on the life of the Canadian individual will not be U.S. property even if the policy is issued by a U.S. entity. Life insurance proceeds are included in the deceased's worldwide estate and can reduce the tax credits available under the provisions of the Canada-U.S. Tax Treaty. However, the value of the death benefit can be excluded from the worldwide estate if the deceased did not own the policy. For this reason, it may be advantageous to transfer ownership of the life insurance to a trust or other person to avoid reducing the amount of estate unified credit and marital credit. Planning in this regard should be undertaken well in advance of death as transfers made within 3 years of the date of death may not achieve the desired result.

6.5 SUMMARY OF KEY ISSUES

The impact of non-Canadian tax and succession law on Canadians must be appreciated by any advisor providing tax or estate planning advice. This Study

Unit attempts to ensure that the advisor will be aware of situations where laws of other jurisdictions may apply. However, foreign planning should be left to those who specialize in such areas of expertise, including professionals from other jurisdictions.

Key indicators that may indicate further investigation include the following:

- beneficiaries who are non-residents;
- executors who are non-residents;
- assets held that are situated in another country, especially immoveable property (such as real property) and property in civil law jurisdictions;
- citizenship outside Canada, especially in civil law jurisdictions; and,
- U.S. Green Card holders.

6.6 TERMINOLOGY

Annual Gift Tax Exclusion Amount: The amount that can be gifted annually to any particular recipient, without attracting U.S. gift tax.

Lifetime Gift and Estate Tax Exemption Amount: The value of an estate that will not be subject to U.S. estate tax. The exemption amount is the basis for calculating the unified credit. The unified credit, whether the full amount which is available to U.S. persons or the pro-rated amount which is available to non-resident aliens, will always offset all the U.S. estate tax on an estate with a worldwide value equal to or less than the Lifetime Gift and Estate Tax Exemption Amount in the year of death.

Marital Deduction: The deduction available under U.S. domestic law for the first to die of a married couple where both are U.S. citizens or other persons taxed as U.S. taxpayers, including U.S. citizens or U.S. Green Card holders. The deduction defers the U.S. estate tax on any amount left to the surviving spouse or certain spousal trusts, until the death of the surviving spouse. Married Canadians who are both non-resident aliens may only benefit from the marital deduction if the property is left for the benefit of the surviving spouse in a Q-DOT and no marital credit is claimed.

Non-Resident Alien: A person who is not a citizen of the U.S., or who is not otherwise a U.S. taxpayer. Under U.S. gift and estate tax law residency is based on where an individual is "domiciled." The concept of "domicile" is different than residency for income tax purposes. A non-resident alien for gift and estate tax purposes is not a U.S. citizen, or a U.S. Green Card holder or foreign person who is "domiciled" in the U.S.

Resident Alien: For U.S. income tax purposes, this includes a U.S. Green Card holder or a foreign person who meets the substantial presence test but who has not claimed a closer connection exception (not available for U.S. Green Card holders) or a treaty exemption. For gift and estate tax purposes, this includes U.S. Green Card holders and foreign persons who are "domiciled" in the U.S.

Unified Estate Tax Credit: The amount of the U.S. estate tax that can be sheltered by the Lifetime Gift and Estate Tax Exemption Amount. A U.S. citizen or resident alien will be able to claim the full amount, but a non-resident alien is entitled to a pro-rated amount based on the proportion of the value of the deceased's estate, which represents U.S.-situs property.

U.S. Citizen: An individual who has U.S. citizenship. A person born in the U.S. or a person who is born to a U.S. parent in a foreign country may have U.S. citizenship depending on what year they were born and how much time the U.S. citizen spent living in the U.S. before he or she turned 18.

U.S. Taxpayer: An individual who is a U.S. citizen or U.S. resident alien for U.S. income tax purposes.

U.S.-Situs Property: For the purposes of the U.S. rules this is property that is subject to U.S. estate tax and U.S. gift tax for persons who are non-resident aliens of the U.S. certain intangible U.S. property is U.S. property for the purposes of U.S. estate tax, but not for the purposes of U.S. gift tax.

REVIEW QUESTIONS AND ANSWERS

Each of the study materials has its own questions and answers that should be reviewed. Additional questions are below:

Questions

1. True or False:

   For the purposes of U.S. estate tax, worldwide property includes:

   (a) The death benefit from life insurance held by the deceased, where the deceased was the insured, regardless of who is named as beneficiary.

   (b) The full value of a registered plan owned by the deceased at death.

   (c) The value of the U.S. condominium that was transferred to the deceased's children prior to his death.

   (d) 50% of the value of jointly held property between the deceased and his or her spouse.

2. True or False:

   (a) A U.S. citizen is generally subject to U.S. estate tax on his or her worldwide estate, but this will not apply if the U.S. citizen moves to Canada and applies for Canadian citizenship.

   (b) U.S. estate tax may be payable if the worldwide estate of a Canadian exceeds the value of $5,490,000 and the individual died in 2017.

   (c) As long as no U.S. estate tax is payable and the value of the estate does not exceed the Lifetime Gift and Estate Tax Exemption Amount, then no U.S. estate tax return has to be filed.

   (d) The amount of the unified estate tax credit available to a non-resident alien to reduce U.S. estate tax payable depends on the year of death, the cost of the U.S. property owned at death, and the proportion of the value of the estate that constitutes U.S.-situs property.

(e) Income tax can be avoided by placing assets received from a foreign person in a foreign trust.

(f) Canadian residents are required to report on an annual basis the ownership of foreign property where the total fair market value of the foreign property exceeds $100,000.

(g) Canadian residents are required to report on an annual basis the ownership of vacation properties located in foreign jurisdictions that are exclusively for personal use.

(h) U.S. Green Card holders who reside in Canada and who do not own property in the U.S. and who have no intention to move back to the U.S. will still be subject to U.S. estate tax on their worldwide estate.

3. U.S. estate tax rules are not the same for U.S. citizens who are resident in Canada and Canadian residents who are non-resident aliens of the U.S. List four (4) differences.

4. Explain how reducing the value of the worldwide estate by making lifetime gifts of property might reduce or eliminate exposure to U.S. estate tax on the death of a Canadian resident who is a non-resident alien of the U.S. Give explanations for gifts of both U.S.-situs property and other property. What dangers lie in making lifetime gifts of U.S. property for Canadian residents who are non-resident aliens of the U.S.?

5. What is the difference between U.S. gift tax and U.S. estate tax rules as they apply to U.S. securities held by a Canadian resident who is a non-resident alien of the U.S.?

6. Compare the U.S. estate tax treatment of shares of a U.S. holding corporation to shares of a Canadian holding corporation, assuming they are held on death by a non-resident alien of the U.S. How would your answer differ if the deceased was a U.S. citizen?

7. Graham died in 2017 with a worldwide estate of $8,000,000USD. Graham is a single Canadian resident (not a U.S. citizen or U.S. Green Card holder) and has a condominium located in Hawaii worth $1,500,000USD.

(a) What is Graham's possible exposure to U.S. estate tax?

(b) If the maximum unified estate tax credit for 2017 was $2,141,800 for U.S. citizens, what was Graham's U.S. net estate tax payable?

(c) Would your answer be different if Graham was married and left the condo to his wife who is a U.S. citizen resident in Canada?

8. Paula and George each hold assets in their own names worth $4,000,000 and $2,000,000 respectively. Paula's assets include a portfolio of U.S. stocks worth $1,000,000. Paula understands that at least for 2017, she need do no U.S. estate tax planning.

(a) What comments might you make about her understanding?

(b) What planning ideas might you suggest to her and George?

Answers

1. True or False:

(a) True. The value of the life insurance owned by the deceased would be included in the value of the worldwide estate.

(b) True. The value of the registered plan would form part of the worldwide estate.

(c) False. The value of the U.S. condo would not form part of the estate, but the transfer to the children may have been subject to U.S. gift tax.

(d) False. U.S.-situs property that is held jointly with a right of survivorship is fully included, unless the taxpayer can provide evidence that the joint owners contributed jointly to the account or to purchase the property.

2. True or False:

(a) False. A U.S. citizen wherever resident is subject to U.S. estate tax on his or her worldwide estate. Applying for citizenship in a foreign country will not affect this exposure. The only way a U.S. citizen can eliminate this exposure is by renouncing his or her U.S. citizenship.

(b) True. An estate that does not have a value that exceeds the Lifetime Gift and Estate Tax Exemption Amount will not be subject to U.S. estate tax.

(c) False. Even if no U.S. tax is payable, a U.S. estate tax return is required to be filed if the value of the U.S.-situs property exceeds $60,000USD.

(d) False. The amount of the unified credit to reduce U.S. estate tax payable depends on the year of death, the *value* of the U.S. property owned at death, and the proportion of the value of the estate that constitutes U.S.-situs property.

(e) False. Special complex provisions exist where a foreign trust may still be subject to Canadian income tax on its worldwide income.

(f) False. Canadian residents are required to report on an annual basis the ownership of foreign property on the T1135 Foreign Income Verification Statement where the *aggregate cost* of the foreign property exceeds $100,000.

(g) False. Vacation properties that are exclusively used personally are not required to be reported on the T1135 Foreign Income Verification Statement.

(h) True. Green Card holders who are not domiciled in the U.S. are not subject to U.S. estate tax.

3. Four differences between the application of U.S. estate tax to Canadian residents who are non-resident aliens of the U.S. and Canadian residents who are U.S. citizens:

(a) U.S. citizens are taxed on the value of their assets held worldwide, whereas Canadian non-resident aliens are taxed only on U.S.-situs property.

(b) U.S. citizens are entitled to the full amount of the maximum unified estate tax credit for the year of death, whereas Canadian non-resident aliens are only entitled to a pro-rated portion of the Unified Estate Tax Credit.

(c) U.S. citizens can always completely defer U.S. estate tax on all property left to a surviving spouse or certain spousal trusts by using the marital deduction, but Canadian non-resident aliens are only entitled to the marital deduction in limited circumstances (only on property passing to a Q-DOT and where the estate waives the marital credit otherwise available under the treaty).

(d) U.S. citizens are not entitled to the marital credit under the Canada-U.S. Tax Treaty, which only Canadian non-resident aliens can use.

4. Gifts of any property will reduce the worldwide estate. If the value of the worldwide estate is below the Lifetime Gift and Estate Tax Exemption Amount for the year of death, no U.S. estate tax will be payable. Reducing the value of the worldwide estate will also increase the amount of pro-rated unified credit available.

   In addition, gifts of U.S.-situs property will reduce the amount of tax payable before the application of the pro-rated Unified Estate Tax Credit (tentative tax). The danger of gifting U.S. property is the application of U.S. gift tax. **NOTE:** In addition, where there is a gift of U.S.-situs property, if the Canadian attribution rules apply to the gift (such as where the gift is made to a spouse) and if U.S. estate tax is payable, there may be a mismatch of tax credits available if the donee dies first. The U.S. estate tax will be a liability in the U.S. estate tax return of the deceased spouse, but any Canadian capital gains tax on property originally held by the surviving spouse will be taxed in the hands of that surviving spouse when the asset is disposed of. Thus, no Canadian credit will be available to the surviving spouse for U.S. estate tax paid by the estate and double tax could occur.

5. U.S. gift tax does not apply to gifts of intangible U.S. property like U.S. securities, but U.S. estate tax does.

6. For a non-resident alien of the U.S. shares of a U.S. corporation are considered part of his or her worldwide estate and subject to U.S. estate tax, whereas the shares of a Canadian corporation are not. For a U.S. citizen both shares of a U.S. corporation or shares of a Canadian corporation would be subject to U.S. estate tax, as a U.S. citizen is subject to U.S. estate tax on all property held on death wherever situated.

7. Graham

(a) Possible estate tax exposure for U.S. condo

On the first $1,000,000	$345,800
On the remaining $500,000 (at 40%)	$200,000
Tentative Tax	$545,800

(b) Pro-rated Unified Estate Tax Credit

1,500,000/8,000,000 = 18.75% x $2,141,800 = $401,588

Graham will be subject to net U.S. estate tax of $144,212

(c) Yes. No estate tax would be payable because of the marital deduction available when assets are transferred to a U.S. spouse that permits the deferral of U.S. estate tax until the death of the surviving spouse.

8. Paula and George

(a) Paula may have no U.S. estate tax if she dies in 2017 because her worldwide estate has a value of less than $5,490,000USD. However, she or George could be exposed to U.S. estate tax on the death of the surviving spouse if they are leaving all or a portion of their estates to each other. For example, if she and George both die one month apart in 2017, the value of the estate of the surviving spouse will include the property inherited from the other, possibly causing the value of the estate of the second to die to exceed the Lifetime Gift and Estate Tax Exemption Amount.

(b) Giving U.S. estate tax advice if you are not an expert is dangerous. You might advise Paula and George to seek U.S. advice from a professional who has this expertise or work with such an advisor on their behalf. Some possible planning ideas (only to be confirmed by a U.S. tax advisor) might include:

i. Moving her U.S. portfolio to a Canadian holding corporation. Advice should be obtained regarding the potential application of U.S. anti-avoidance rules. These might dictate a requirement that

there be other planning objectives motivating the incorporation of the portfolio, such as probate taxes, or other estate planning.

ii. Using a spousal trust for George in her Will with terms that result in the property being subject to the Canadian spousal rollover rules, as well as being excluded from the estate of the surviving spouse for U.S. estate tax purposes. This requires special structuring and U.S. advice is essential. If George has no U.S. property, this will provide complete relief if Paula dies first. However, if George dies first and Paula is a beneficiary of his estate, Paula's estate may exceed the Lifetime Gift and Estate Tax Exemption Amount and the U.S. portfolio will be subject to U.S. estate tax. To avoid this result, George should also create a spousal trust for Paula to keep her estate below the Exemption Amount for 2017.

APPENDIX 6.1

STEP Diploma Program, *Wills, Trust and Estate Administration*, Wendy D. Templeton, Chapter 14, Foreign Property, Multiple Jurisdictions and Succession

CHAPTER 14

FOREIGN PROPERTY, MULTIPLE JURISDICTIONS, AND SUCCESSION

LEARNING OBJECTIVES

14.1 INTRODUCTION 14-3

14.2 MULTIPLE JURISDICTIONS AND FOREIGN LAW 14-4

14.3 DOMICILE AND RESIDENCE 14-6

14.4 MOVABLE AND IMMOVABLE PROPERTY 14-7

14.5 APPLICATION OF LAW GOVERNING SUCCESSION 14-7

14.5.1 Law Governing Estate Administration 14-8

14.5.2 Law Governing Succession of Property — Estate Distribution 14-8

14.5.3 Intestate Distribution within Canadian Provinces and Territories 14-9

14.5.4 Testamentary Succession within Canadian Jurisdictions . . . 14-9

14.5.5 Dependant Relief in Canada 14-10

14.5.6 Summary of Choice of Law Rules 14-10

14.6 FORCED HEIRSHIP 14-11

14.6.1 Examples of Countries Where Forced Heirship May Affect Canadian Estates 14-12

14.6.2 Application of Forced Heirship Rules 14-13

14.7 CASE STUDIES OF FORCED HEIRSHIP 14-13

14.8 INHERITANCE AND ESTATE TAX 14-15

This document is an excerpt from the STEP Diploma course on Wills, Trust & Estate Administration (2011).
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Chapter 14

Foreign Property, Multiple Jurisdictions, and Succession

Learning Objectives

Knowledge Objectives

- Understand how the laws of other jurisdictions can apply to succession of foreign property

Skills Objectives

- Explain the difference between residence and domicile
- Identify movable property and immovable property
- Describe the importance of identifying the law governing making a Will and the succession of foreign property

14.1 INTRODUCTION

Where an individual owns property in another province or country, particularly real property or "immovable property," it may be appropriate to have a separate Will, or an international Will (if applicable in that jurisdiction (see 3.7.6, International Wills)), to deal with property in the other jurisdiction to facilitate administration of the foreign estate (see also 3.7.5.1, Property Outside the Jurisdiction).

This chapter deals more particularly with identifying client situations in which foreign law may affect the succession of property of a deceased individual who is resident or domiciled in one of Canada's provinces or territories and assumes that such person is a Canadian citizen except where otherwise noted. Throughout the previous chapters in these materials it has been assumed that the deceased individual is both resident

and domiciled in the same province or territory. However, this chapter will examine the difference between residence and domicile and how the application of laws of succession will vary under conflict of laws rules if residence and domicile are not in the same jurisdiction, both internationally and within Canada.

14.2 MULTIPLE JURISDICTIONS AND FOREIGN LAW

The choice of law rules under conflict of laws will determine how the laws of other jurisdictions may apply to testate and intestate succession. The specific effect of foreign laws on the succession of property of Canadian residents is beyond the scope of this material. It is essential that the potential application of laws outside Canada (or of another jurisdiction within Canada) is recognised and that specialised professional advice, including advice from professionals in other jurisdictions, be obtained where appropriate.

Throughout these materials it has also been implicitly assumed that the law of the province or territory of residence generally governs matters relating to succession, including Wills, intestacy, claims against an estate, and estate and trust administration (although there has been a separate discussion of the application of the law of Quebec). This is not necessarily the case. Within Canada, the laws of a province or territory other than that of residence may apply. This could occur where:

- there is property in another jurisdiction,
- there is a dependant or beneficiary in another jurisdiction, or
- the individual is domiciled outside the province or territory of residence.

Questions of jurisdiction and application of laws of other provinces, territories, and countries may arise in a number of circumstances. In this chapter the focus will include the laws of other countries, although it is important to recognise that laws of other provinces and territories may also impact Wills, succession, and administration of estates and trusts, and these are also discussed.

It is beyond the scope of these materials to specifically identify all situations in which the laws of other jurisdictions may affect the succession of property or administration of an estate or trust under a Will of an individual resident in Canada. However, as a general guideline, the laws of a foreign jurisdiction, either its national law if it has a

unitary political system of government or that of a province or state within a foreign country that has a federal system, may apply where:

- the individual has his or her domicile in another country even though resident in Canada,
- the individual is a citizen, sometimes called a "national," of another country, or
- property is located in another jurisdiction.

Conflict of laws rules determine three issues:

1. which court has jurisdiction to determine an issue,
2. which law applies to a particular issue, and
3. whether a court will enforce the legal judgment of another jurisdiction.

This chapter mainly focuses on item 2 and identifies situations where the law of other jurisdictions might impact on succession of property of a person who died resident or domiciled in Canada. The conflict of laws rules can be helpful in many cases to determine which law applies.

However, it is not an easy task to determine how the rules apply since not only are the concepts and principles complex but also each jurisdiction may have its own conflict of laws rules, which in turn may result in different outcomes.

Conflict of laws rules generally include a consideration of a number of factors or concepts.

- The "*situs*" of property, or its location for legal purposes, which is divided between movable and immovable property under common-law principles with different choice of law rules for each type.
- Citizenship
- Domicile
- Residence

Whenever a Canadian resident or citizen is domiciled in another country, is a citizen of another country, or has property in another country, particularly immovable property, the laws of that other country may apply to the succession of property in that country upon his or her death.

14.3 DOMICILE AND RESIDENCE

Laws relating to personal matters of individuals, including laws of succession, are usually decided on the basis of the laws of the place where the individual has his or her permanent home. For this purpose it is recognised that an individual may reside in one place, perhaps temporarily, but have his or her permanent home in another place to which at some time in the future he or she contemplates returning on a permanent basis. This is the concept of domicile.

There are three types of domicile.

1. **The domicile of origin** is determined at birth by the place of birth and will continue to be the domicile of an individual throughout his or her life unless one of the other domicile rules subsequently applies.

2. **Domicile of choice** is the place where an individual, after attaining the age of majority, takes up residence with the intention of remaining indefinitely.

3. **Domicile of dependency** is conferred by operation of law upon those persons who, by reason of legal or mental disability, are unable to acquire a domicile of choice, including minors and certain mentally incapable persons.

In some jurisdictions outside Canada, domicile of birth or dependency may be determined by the domicile of the father, or that of the mother if born outside marriage.

Domicile and residence are not the same, although for many individuals the place of residence will be the place of domicile unless he or she has an intention to return in the future to live permanently in another jurisdiction (usually where he or she was domiciled in the past).

Domicile may be the place where the person has his or her residence or the place where the person has the centre of his or her affairs, the seat of his or her wealth, and the affection of his or her family.

For example, a business executive who is transferred from the U.S. to work for the Canadian subsidiary of his corporate employer may remain domiciled in the U.S. if he or she retains connections in the U.S. and/or intends to return to the U.S. when the work assignment is completed or in retirement and does not intend to remain permanently within Canada.

14.4 MOVABLE AND IMMOVABLE PROPERTY

Movable property includes any property that is portable. The legal definition of movable property includes all personal property, such as goods, chattels, and personalty. It also includes intangible property, such as negotiable instruments and securities.

Immovable property includes real property, anything permanently affixed to real property, or any interest in real property. Immovable property includes land, buildings, mining rights, leaseholds, and rights to receive rent or income from real property.

The *situs* of property is the location of property for legal purposes, such as taxation and conflict of laws. The *situs* of real property is generally the jurisdiction where the property is physically located. For intangible personal property, which has no physical attributes, the rules vary. Generally debts are considered located where the debtor resides. Registered shares of corporations were originally considered to be located in the place where the share register of the corporation was maintained and a transfer of the shares could be effected or the jurisdiction where the corporation was incorporated. With more modern investment practices, shares are often held with financial intermediaries and may exist only in electronic records with no share certificate. The location of shares and other financial intangibles in these circumstances is difficult and the law is evolving.[1]

14.5 APPLICATION OF LAW GOVERNING SUCCESSION

Under conflict of laws rules, the choice of law that applies for the purposes of succession depends on whether the property is movable or immovable. For movable property, generally, the law of the domicile of the deceased governs, and for immovable property the law of the jurisdiction where the property is located (the "*lex situs*") governs.

1 See, for example, *Re Bloom Estate* (2004), 27 B.C.L.R. (4th) 176 (S.C.), where the *situs* of publicly traded shares held in an electronic account were found to be located at the securities department of the financial intermediary in Ontario and not subject to probate fees in British Columbia.

Under Canadian common law, as a general rule indirect interests in land located in Canada (such as mortgages) may be considered immovable for the purpose of determining the *lex situs* for the purpose of conflict of laws rules, even though they are personalty for the purposes of domestic law (i.e., the applicable succession law that applies once the jurisdiction governing the property has been chosen) with perplexing results.[2] In one case, for example, mortgages secured against land in British Columbia were not subject to probate fees in Saskatchewan since for probate fee purposes they were considered immovable, but they were governed by the law of Saskatchewan for the purposes of succession and distribution on intestacy as for this purpose they were considered personalty.[3]

In addition, Canadian courts generally take the position that they have no jurisdiction with respect to land or real property outside Canada.

So, for example, suppose country X has forced heirship rules and the laws of succession in X apply to all citizens of X. An individual who is a citizen of X with real property located in X may need to address the forced heirship rules in X even if he or she is resident or domiciled in Canada.

14.5.1 Law Governing Estate Administration

The law of the administration of the estate generally is the law of the country where the personal representative received the original grant of probate. Within Canada the grant is usually issued from the jurisdiction in which the Canadian resident had his or her residence or where his or her property is located. Provincial rules will dictate whether or not the grant can be obtained in the province, and provincial statutes may allow for grants even if there is no property in the province if the deceased was resident or domiciled in the province.

Once the grant of probate has been issued in the principle jurisdiction, the grant may be used in another jurisdiction as an ancillary grant or resealed grant, to deal with property in that other jurisdiction.

14.5.2 Law Governing Succession of Property — Estate Distribution

With respect to matters of succession relating to distribution of property to beneficiaries, including intestate distribution, capacity to make a Will, and dependant

2 Stephen G.A. Pitel and Nicholas S. Rafferty, *Conflict of Laws* (Toronto: Irwin Law, 2010) at 309-310.

3 *Hogg v. Provincial Tax Commission,* [1941] 4 D.L.R. 501 (Sask. C.A.).

relief, these matters are governed by the law of the last domicile of the deceased for movable property and by the law of the *situs* of immovable property. Generally these are also the rules under which forced heirship rules of foreign countries may apply.

14.5.3 Intestate Distribution within Canadian Provinces and Territories

For the purposes of intestate distribution within Canadian jurisdictions, the law of the domicile will apply to movables and the law of the *situs* will apply to immovables.

Assume John, who was domiciled in Ontario, died intestate and owned a ski chalet in Whistler, British Columbia, at the time of his death. The law of Ontario will determine the distribution of all his real and personal property located in Ontario and all personalty outside Ontario. However, the law of British Columbia will apply to the intestate distribution of his British Columbia property. This could result in multiple preferential shares being accumulated for the benefit of the spouse to the detriment of his children's entitlement. However, the courts have resisted this result, tending to avoid "double dipping" by restricting the aggregate preferential share to the highest amount available among the relevant jurisdictions.[4]

14.5.4 Testamentary Succession within Canadian Jurisdictions

The common-law rule is that the choice of law for testamentary succession is the law of the *situs* in the case of land and the law of the last domicile of the deceased for movable property. However, most provincial and territorial statutes have permitted testators to use the forum of several different countries with respect to movables. For example, the Alberta *Wills and Succession Act*[5] and the Ontario *Succession Law Reform Act*[6] allow other laws to be considered with regard to the formal and essential validity of a Will.

The law of testamentary succession includes the formal validity of a Will (i.e., execution), capacity, essential validity of the Will, and interpretation of the Will. "Essential validity" of a Will includes questions such as the validity of gifts to witnesses or relatives of witnesses, forced heirship, compliance with the rule against perpetuities and accumulations, the validity of a charitable gift, testamentary capacity, and whether a Will was free and voluntary and not subject to fraud, mistake, or undue influence sufficient to make it invalid.

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4 *Re Thom Estate* (1987), 50 Man. R. (2d) 187 (Q.B.), although a slightly different approach was adopted in *Re Valt Estate* (1994), 20 OR. (3d) 378 (Gen. Div.) with annotation by Vaughan Black (1994), 4 E.T R. (3d) 2.

5 R.S.A. 2010, c. W-12, ss. 41-45.

6 R.S.O. 1990, c. 26, ss. 36-41.

14.5.5 Dependant Relief in Canada

The ability to make a claim for dependant relief within Canada, in terms of the court's jurisdiction, is not necessarily confined to the laws of the jurisdiction in which the deceased was domiciled. Generally the applicable legislation contains no conflict of laws rules. An award for relief affects testamentary freedom. In *Corlet*,[7] a widow who had resided with her husband in Alberta at the time of his death was not entitled to make a claim for dependant relief in Alberta because her husband was domiciled outside the province at the time of death and all property consisted of movables, which as a result were not considered to be property located in Alberta or subject to such claims.

14.5.6 Summary of Choice of Law Rules

The table in Figure 14.1[8] outlines the choice of law rule depending on the issue and whether property is movable or immovable.

Figure 14.1: Choice of Law Rules[9]

Legal Issue	**Law that Applies to Movable Property[9]**	**Law that Applies to Immovable Property**
Capacity to make a Will, including age requirements	Law of domicile at relevant time — i.e., when Will executed	Law of *situs*
Formal validity of Will (execution)	Law of domicile at death	Law of *situs*
Essential validity of Will (see 14.5.4, Testamentary Succession within Canadian Jurisdiction)	Law of domicile at death	Law of *situs*
Construction of Will	Law intended by testator — rebuttable presumption is law of domicile at time Will made	Same as for movables
Intestacy	Law of domicile at death	Law of *situs*
Dependant Relief in Canada — analogous to essential validity of Wills	Law of domicile at death	Law of *situs*

7 *Re Corlet Estate,* [1942] 2 W.W.R. 93 (Alta. S.C.).

8 This table is taken in part from Margaret R. O'Sullivan, *Dealing with Assets Outside the Jurisdiction,* presented at the Ontario Bar Association, Trusts and Estates Section, February 23, 2010, and is used with the author's permission.

9 Note that Canadian provincial law, including that in Alberta and Ontario, may permit variation with respect to movables. See 14.5.4, Testamentary Succession within Canadian Jurisdiction, and Pitel and Rafferty, *supra* note 2 at 355-357.

14.6 FORCED HEIRSHIP

Forced heirship refers to laws that limit testamentary freedom by providing that on death property must pass to certain family members of the deceased. Forced heirship is part of the succession law of civil jurisdictions, such as those in Latin America and continental Europe. In addition, Muslim countries, such as Saudi Arabia, have forced heirship laws based on Sharia law. Generally under the forced heirship rules, the surviving spouse, children, and other relatives of a deceased person are entitled to receive fixed shares or specific property in the estate. Usually the forced heirship rules apply only to certain property, or to a portion of the estate, leaving the deceased person to dispose of the remainder of his or her estate by Will as he or she chooses.

Forced heirship can be likened to the rules of intestacy. Intestate distribution is, by formula, among family members where there is no Will. Forced heirship provides a formula for distribution among family members that overrides or takes precedence over the Will.

In Quebec, the automatic right to family patrimony of a surviving spouse as a first charge on the property of the estate is a form of forced heirship since the right to payment takes precedence over the Will. Rules relating to spousal rights on the death of one's spouse in respect of the deceased spouse's property in the common-law jurisdictions and to dependant relief can also be considered a form of forced heirship, although they usually require a court application and have subjective criteria that affect the entitlement. Forced heirship rights are usually automatic and prescribed by a formula that is dependent only on the relationship to the deceased and the size of the estate.

The rules of forced heirship depend on the jurisdiction. Generally transfers on death that violate the forced heirship rules are void or voidable or the property may be clawed-back into the estate if gifts have been made during lifetime that offend the forced heirship regime.

For a worldwide map of legal systems showing common-law, civil-law, customary-law, and Muslim-law jurisdictions, see the website project of the University of Ottawa at http://www.juriglobe.ca/eng/index.php.

The Hague Convention on the Law Applicable to Trusts prescribes rules for determining the applicable law to govern a trust. Article 15 requires subscribing states to honour mandatory succession rights, especially those of the spouse and

relatives. In Canada, eight of the provinces have ratified the Hague Convention: British Columbia, Alberta, Saskatchewan, Manitoba, New Brunswick, Prince Edward Island, Nova Scotia, and Newfoundland and Labrador. None of the territories or Ontario or Quebec are parties to the Hague Convention on the Law Applicable to Trusts.[10]

Some offshore jurisdictions, such as Bahamas, have enacted rules to permit individuals in certain circumstances to protect their estates against forced heirship claims.

Forced heirship is part of Sharia law and may apply in Muslim countries. Testators in Canada who are Muslim may wish to voluntarily comply with the forced heirship formula even though it has no legal authority in Canada.

14.6.1 Examples of Countries Where Forced Heirship May Affect Canadian Estates

European countries with forced heirship rules, whereby certain family members of the deceased have mandatory succession rights, include Belgium, Cyprus, France, Germany, Italy, the Netherlands, Portugal, Spain, and Sweden. However, there are particular details to be aware of in each of these jurisdictions. The list below is a sample of the highlights in some of these countries and is not complete.

- **Cyprus:** Forced heirship may apply to the estates of persons who are domiciled in Cyprus unless the individual or his or her father was born outside Cyprus in a country of the British Commonwealth. Immovable property located in Cyprus may be subject to the laws of succession in Cyprus regardless of the status of the deceased owner.[11]

- **France:** Forced heirship applies to all property. Under conflict of laws rules, if the person is domiciled outside France, forced heirship rules will apply only to immovable property in France.

- **Germany:** Forced heirship applies to German nationals. Thus, the estate of German citizens is subject to forced heirship rules in favour of the surviving spouse, descendants, or parents of the deceased.

10 It should be noted that Canada is not a party to the Hague Convention on the Law Applicable to Succession to the Estates of Deceased Persons. The Hague Convention on the Law Applicable to Succession to the Estates of Deceased Persons deals with creating rules for succession to property on death primarily based on "habitual residence" for the limited number of jurisdictions who have signed and ratified it.

11 STEP Directory and Yearbook, 2016, at 201.

- **Monaco:** Forced heirship will apply to Monegasque nationals.
- **Spain:** Forced heirship laws apply to Spanish nationals.

14.6.2 Application of Forced Heirship Rules

As has already been discussed at 14.2, Multiple Jurisdictions and Foreign Law, the choice of law rules can be extremely difficult to apply, and thus it may be appropriate to seek additional professional advice, including opinions from the foreign jurisdictions involved. For example, in jurisdictions where forced heirship rules apply to nationals (i.e., citizens) of a particular country, their application may extend further to persons who are not nationals of the particular jurisdiction. This could occur because the choice of law rules may refer to another jurisdiction, which in turn may refer to a further jurisdiction to determine which law governs. This is the result in Monica of Monaco (see the case studies in 14.7).

14.7 CASE STUDIES OF FORCED HEIRSHIP[12]

Monica of Monaco

Monica was born in Belgium and is a Belgian national. She marries Randall, a Canadian citizen, who was born and raised in Thunder Bay, Ontario. Monica and Randall reside in Ottawa, where they raise a family and have successful careers in government and the high-tech industry, respectively. They acquire a luxury condominium in Monaco, in Randall's name, ornately decorated with Monica's valuable European art collection, which she inherited from her parents. They then become non-residents of Canada and retire to Monaco to enjoy lots of sunshine, fine wine and cuisine, and low taxes.

Unfortunately, their plans are short-circuited when Monica unexpectedly passes away, only a few years after their retirement.

Issues: What law governs succession to Monica's art collection? Is Monica's Ontario Will (which she executed several years before her departure from Canada), which provides for a trust to hold her art collection for Randall's lifetime use with the remainder of her estate outright to Randall, valid?

12 These examples are taken from Margaret R. O'Sullivan, *supra* note 8, and used with the author's permission.

Analysis: To deal with the issues, the governing law (choice of law) under conflict of laws rules must be determined; specifically, what is the governing law for:

- the validity of Monica's Will?
- the law for succession of her art collection?

Monica was resident in Monaco and a national of Belgium at the time of death. Monaco law refers to the law of nationality in general, including private international law (not just the internal law), to determine the validity of her Will should she die resident in Monaco.

The law of Belgium would be referred to since Monica was a Belgian citizen. Belgian law provides that the law of the person's "domicile" (under Belgian law that means the place where the person had their principal "establishment" or residence) is the law governing the validity of the person's Will for any movable property. Therefore, Monegasque law will apply to determine the validity of Monica's Will, since she was resident in Monaco at the time of death.

Monegasque law does not, in general, recognise the common-law concept of the trust. Therefore, the trust for her art collection under her Will may not be valid. Monegasque law would not allow all of Monica's estate to pass to Randall since it has a "forced heirship" regime that requires her children receive a share of her estate.

French Retreat

Robert and his wife, Heather, frequently travel together throughout Europe for their gourmet food import business. They decide that it would make sense to have a residence as a base for their business travels — and for pleasure — and settle on a seaside villa on the south coast of France near St. Tropez. They take title each as to a 50% interest.

Their Ontario lawyer, in taking instructions for their Wills, obtains French advice as to how to deal with the French residence. They are advised under French law that forced heirship rules law prevent them from passing the property to each other absolutely on death. If this is their objective, one approach is to have each of them have a French Will gifting the maximum amount allowed under French law to the other and rely on their four children to gift or release the interest they are each entitled to receive to their surviving parent. They proceed to execute French Wills to that effect.

Several years later, Robert dies. Heather, who is the executor under the French Will, decides to sell the property. At death, the residence had a value of €1,000,000.

What is the process and outcome?

Although Heather is the executor, on the death of Robert, his interest in the residence, subject to liabilities, is transmitted to the heirs under forced heirship rules.

Under French law, Heather and her four children have a right to receive a share of the property or its proceeds. If the children "waived" their rights, Heather could become the sole owner and could proceed to sell the property without the involvement of the children. In this particular situation based on the values and facts, French advice is that in light of the value of the property, each child should not waive his or her interest, and the property should pass to them to minimise French succession duty since each beneficiary has an exemption that can be utilised for such purpose. The sale can take place after the distribution, and after the sale each child could choose to gift the sale proceeds he or she receives to Heather.

14.8 INHERITANCE AND ESTATE TAX

Many countries impose inheritance or estate taxes of one kind or another. Such taxes may apply to citizens of the country regardless of residence or to those who are domiciled in the country regardless of residence or citizenship.

For example, the U.S. imposes the U.S. estate tax on the worldwide property of any "U.S." person no matter where resident. "U.S." person means any individual who is

domiciled in the U.S., has U.S. citizenship, or holds a U.S. green card. Even Canadian residents who are not considered U.S. persons are subject to the U.S. estate tax regime on assets considered situate in the U.S. The U.S. system has some unique features.

- A U.S. resident who is still domiciled in Canada is exempt from U.S. estate tax except in respect of his or her U.S. *situs* property. However, it is likely that the U.S. revenue authorities would argue that the individual is domiciled in the U.S. if he or she resided there other than on a temporary basis.

- U.S. citizens living in Canada are also subject to U.S. estate tax on their worldwide estate under U.S. law, even if there is no property located in the U.S., and are entitled to restricted treaty relief.

- The estate of a Canadian resident may be subject to U.S. estate tax if the deceased owned U.S. "*situs*" property on death, although the tax will be payable only on U.S. *situs* property. "U.S. *situs* property" for this purpose includes not only real property or an interest in real property located in the U.S. but also other property, including securities issued by a U.S. entity such as shares of a U.S. public corporation.

- The worldwide estate of a Canadian resident may be subject to U.S. estate tax if he or she holds a U.S. green card that has not been surrendered as the U.S. may consider he or she is "domiciled" in the U.S.

Many other countries, including the U.K., impose inheritance taxes in respect of certain property located in the foreign jurisdiction.

STUDY UNIT SEVEN

CASE STUDIES

7.1 CASE STUDY SCENARIOS 7-2

7.1.1 Case Study 1: The Greenbacks' Estate Plan 7-2

7.1.2 Case Study 2: The Greenbacks' Estates 7-3

7.1.3 Case Study 3: Loonie and Jack: The Next Generation 7-5

7.1.4 Case Study 4: Big Banana 7-7

7.2 ANSWERS TO CASE STUDIES 7-8

7.2.1 Case Study 1: The Greenbacks' Estate Plan 7-8

7.2.2 Case Study 2: The Greenbacks' Estates 7-10

7.2.3 Case Study 3: Loonie and Jack: The Next Generation 7-14

7.2.4 Case Study 4: Big Banana 7-17

7.1 CASE STUDY SCENARIOS

7.1.1 Case Study 1: The Greenbacks' Estate Plan

Penny and Nicholas Greenback, age 65 and 67, have three children, Loonie, Toonie, and Bill.

Bill suffers from Down's Syndrome and has been in a group home since he was 16. He is now 36 and is single with no children.

Loonie, age 41, is the oldest daughter. She is married with three children and has a busy career as a marketing executive. Her husband Jack is a chartered accountant with a large international public company and he travels frequently both within Canada and throughout Europe and the U.S.

Toonie, the youngest daughter, age 33, has had two failed marriages and is currently living common law with Bert. She has one son, Sam, from a previous marriage, and she and Bert have one daughter together.

Toonie is very bright but never achieved academic success like her sister. Her parents are currently funding her educational expenses and daycare costs so she can complete her training and qualify as a registered nurse.

Penny and Nicholas' assets are as follows:

Asset	Penny	Nicholas	Joint with right of Survivorship or last to die	Designation
Residence			$425,000	
Bank Accounts	$10,000		$35,000	
Life Insurance	$125,000	$300,000		none
Joint last to die Life Insurance			$200,000	none
Registered Plans	$230,000	$35,000		Spouse
Registered Plans	$68,000			Spouse
Investment Accounts	$640,000	$800,000		

Asset	Penny	Nicholas	Joint with right of Survivorship or last to die	Designation
Cottage (in Ontario)			$185,000 with Loonie	
TFSA	$11,500	$20,500		Spouse

Penny and Nicholas have Wills and Powers of Attorney for Property and Health Care Directives. Their Wills are "mirror Wills" leaving everything to each other providing the spouse survives by 30 days, with a gift over to their issue in equal shares *per stirpes*. The executor is the surviving spouse, with Penny's brother, Dime, as alternate executor.

Assume Penny and Nicholas wish to review their estate plan with you. Prepare a list of questions to obtain missing information that would be relevant to their estate plan. Explain why these questions are important and how the estate plan might be designed – i.e., what strategies might be appropriate, depending on their answers.

7.1.2 Case Study 2: The Greenbacks' Estates

Penny and Nicholas were killed in a car crash before any new Wills could be executed or any changes could be made, except as noted with respect to the beneficiary designation of one of Penny's RRSPs. Nicholas died instantly and Penny died from her injuries five weeks later in hospital. Penny's brother, Dime, and Loonie have come to see you to review the administration and distribution of Penny's and Nicholas' estates. Dime does not want to act as executor because he has just remarried and is spending six months a year at his winter home in Florida. Loonie is willing to take over as executor but is not sure what is involved and wants advice. She is concerned because Toonie is already asking when she will get her money as she and Bert are thinking about getting married and buying a house. In addition, Loonie is very pre-occupied with her recent separation from Jack, and is concerned that he will be able to "cash in" on her inheritance.

1. What is required in order for Loonie to be able to administer the estate? What might you advise her, taking into account her reluctance to act as administrator? How might Penny and Nicholas have provided for this situation in their Wills?

2. Loonie discovers that her mother changed the beneficiary designation on the registered plan for $68,000 to Loonie. Loonie wants to know the tax consequences of receiving the proceeds. What are they?

3. Explain how the funds from the other registered plans will be paid. Assume Penny did not transfer the funds to her own plan before her death. How will they be taxed?

4. Calculate the assets subject to probate in each of Nicholas' and Penny's estates. How could the value of assets subject to probate have been reduced for Penny and Nicholas? Assume the total expenses in Nicholas' estate including funeral, legal, accounting, income tax, probate fees and executor fees are $100,000.

5. Calculate the net estate for Penny passing under her Will after all expenses (i.e., the amount available for distribution) taking into account your answer and the information in question 4. Assume Penny has no income from any other sources in the year, and that her effective tax rate (i.e., average tax rate) on any income in the terminal return is 50%. Assume the following:

   (a) probate fees payable of 1%,

   (b) funeral expenses of $10,000,

   (c) real estate commission of 5% on the home,

   (d) executors fees of 5%,

   (e) accounting and legal fees of $11,950,

   (f) the cottage was transferred into joint names with Loonie as a true gift and passes outside Penny's estate by right of survivorship. The principal residence exemption is used on the main residence. Penny's cost of her interest in the cottage at the time of her death (including the portion inherited from Nicholas) was $72,500,

   (g) the income tax on Nicholas' registered plan has already been paid by his estate and is included in the $100,000 expenses noted in question 4, and

   (h) capital gains in the estate from investment accounts are $120,000.

6. How will Penny's estate be distributed? Taking into account your answer in question 5, how much will each beneficiary receive? What should the executors do before making any final distribution and why?

7. How would the distribution of the two estates be different if Loonie had died before her parents?

8. Assume there is a hotchpot clause in each of Penny's and Nicholas' Wills requiring that on the death of the surviving spouse, the executor must take into hotchpot the value of the cottage at the time of the death of the surviving spouse in calculating the share of any residual beneficiary. What would the effect of such a clause be?

9. What estate planning advice would you give to Loonie? How might she protect her inheritance from Jack?

7.1.3 Case Study 3: Loonie and Jack: The Next Generation

It is now 10 years after Penny and Nicholas died in Case Study 2. Loonie and Jack reconciled and are now concerned about their own estate planning. They are interested in maximizing any tax planning and tax saving opportunities. While they are comfortable in their marriage, they have kept their assets separate over the years with the exception of the family home which is in joint names. Each of them have group insurance and defined contribution pension plans, but no RRSPs.

Loonie still owns the cottage in her own name and it has appreciated since she inherited it, as it is now worth $600,000. Jack's mother is still alive and while she has enough to get by, Jack does assist her financially from time to time. Last year he purchased a new car for her and paid for repairs needed on her home.

Jack has an illegitimate son from an affair he had while separated from Loonie. He makes voluntary support payments but has no contact with the child or his mother.

Jack and Loonie's three children are all in their 20s. One is married and planning to have a family and the other two are still pursuing their post-secondary educations. All of them have good career expectations.

After discussions with Jack and Loonie you have also discovered a number of factors that will impact their estate plan.

- Jack wants to provide for his illegitimate son by continuing the support payments and funding his post-secondary educational expenses until age 25.
- Both Jack and Loonie are concerned about preserving the inheritance for their children in the event one of them dies and the other remarries.
- Jack and Loonie are concerned about the potential claims that could be made by a son- or daughter-in-law against their children's inheritance.

1. Loonie is concerned about the lakefront cottage. She wants to know how it will be taxed if she sells it now, or holds it until death. She has owned it for 10 years – from 2008 until 2018. She and Jack used their principal residence exemption for the years 2008 to 2012 on a previous home. Assume her tax cost of the property is $160,000. What is the minimum amount she must report if she sells the cottage for fair market value in 2018? Show how this will be reported in her return.
2. If Loonie doesn't sell the cottage now, she is also interested in considering how it can be passed to the children. The family next to her at the lake has transferred the cottage to a family trust and Loonie is interested in how that might work in her situation. Currently only two of the children ever go to the cottage on a regular basis, and the third child has no interest at all in the cottage. What would you advise her and why?
3. What might you suggest regarding Jack's mother?
4. What might you suggest regarding Jack's wish to provide for his illegitimate son?
5. How might Jack and Loonie's estate be distributed on the first death if one of them survives? What strategies would you suggest with respect to passing property to the children? Explain the benefits of using trusts as compared to an outright distribution.
6. Loonie is also concerned about her sister Toonie. She and Bert never married, and they now have two children of their own. Toonie also has Sam from a previous marriage. They have no Wills. Toonie has spent her inheritance from her parents, purchasing their family home, which is in joint names with Bert, and re-building a cottage on a property Bert

inherited from his parents. All assets except the family home are in Bert's name. Loonie is concerned about what will happen to Toonie if Bert dies without a Will. What can you tell Loonie about Toonie's situation if Bert dies without a Will? What would you advise Loonie regarding Toonie's situation?

7.1.4 Case Study 4: Big Banana

Big Banana is a line of children's playwear manufactured by BB Ltd, a Canadian controlled private corporation ("CCPC") which in turn is wholly-owned by another CCPC – BB Holdco. BB Holdco is owned one third by each of Edna, Sonja and Roberto who are sisters and a brother. All the business assets are held by BB Ltd., and BB Holdco has an investment portfolio funded by dividends from BB Ltd. worth $1,500,000. The assets in BB Ltd. include "goodwill" worth $4,000,000 that is not on the balance sheet. Neither corporation has any debt. Applebaum, Banana's accountant, estimates the value of the business is approximately $8,000,000, including the off balance sheet goodwill, but not including the investments in BB Holdco.

1. Assuming that the shares have been held for over 10 years by Edna and her siblings, and that BB Ltd. carries on an active business primarily in Canada, do the shares of BB Holdco qualify for the capital gains exemption? Why or why not? What are the tests that are applicable? What can be done to make the shares of Holdco qualify for the exemption?

2. What reason might you speculate for the existence of BB Holdco, and the reason it has received cash dividends from BB Ltd?

3. If corporate life insurance is to be purchased to fund a buyout on death among the shareholders, which corporation should own the policy or policies and why? Who should be the beneficiary of the policy and why?

4. The accountant for the corporations is urging Edna and her sister and brother to do an estate freeze for the benefit of their children, utilize the capital gains exemption in the course of the freeze, and permit their children future access to the capital gains exemption.

    (a) What must take place before the shareholders can utilize their capital gains exemption?

(b) Which corporation should issue the new common shares in the course of the freeze? Could it be either corporation? Discuss the options relating to a freeze and a crystallization and their consequences to the siblings.

(c) Make recommendations regarding the ownership of the new common shares issued in the course of the freeze. Discuss ownership by one or more trusts, as compared to individual ownership.

7.2 ANSWERS TO CASE STUDIES

7.2.1 Case Study 1: The Greenbacks' Estate Plan

Note that these are suggested questions. There may be many more or less, depending on how the Greenbacks answer the first few questions. The list is not necessarily complete either. In addition, each advisor will have his or her own style as to how these issues will be raised and the nature of the advisor's practice (law, accounting, insurance, trust officer, etc.) will often dictate specific questions. Often some of these questions might be answered in a questionnaire already prepared by the client. The advisor may already be aware of some of the answers because of an existing relationship with the clients, or from a source of referral. They would not necessarily all be asked.

1. How old are their current Wills? If they are very out of date and/or there have been significant changes since the Wills were prepared, it is likely that the whole estate plan should be reviewed and planned "from scratch" rather than just considering changes to the existing plan.

2. Is it still appropriate for Dime to be the executor once they have passed away, or might they be interested in choosing another executor, possibly one or more of their children? Who would be appropriate? The choice of executor is often out of date. Siblings are commonly chosen when children are too young for the responsibility. However, as children mature, they become able to act as executor.

3. What would they like to modify with respect to their current plan? It is important to know what the client's objectives are rather than make assumptions. While the facts raise many issues, it is important to make sure the clients' needs and wishes are addressed – and that any "hidden agenda" or issues involving family dynamics are disclosed or discovered.

4. Does Bill receive or qualify for provincial disability benefits? Are we in a province other than Alberta? If so, the inheritance Bill receives from his parents may disentitle him to such benefits.

5. If Bill does qualify for provincial benefits, would his parents want to preserve the rights to such benefits even though preserving such right might restrict what Bill can inherit directly?

6. Are they interested in using a discretionary trust for Bill to provide for him but make it possible either to distribute unrestricted amounts to him (in which case he might lose benefits) or to restrict what he receives directly so that he continues to meet the means test for provincial benefits?

7. Is Toonie financially responsible? Do they have any concerns about Toonie receiving her inheritance directly, given the unstable nature of her relationships and the fact that she needs financial assistance from them? If so, it might be appropriate to suggest a trust to provide financial security for Toonie and her two children.

8. Are they interested in making any charitable gifts?

9. Is the cottage owned jointly with a right of survivorship? What are their intentions with respect to the cottage? Did Loonie contribute to the purchase price, or was it transferred to her by way of gift? If the cottage was transferred into joint names with Loonie without consideration and there is no documentation regarding their intentions, the cottage will be part of their estate. If this is not what they want, they need to document their intentions.

10. Are they aware that the insurance will form part of their estate if no beneficiary is designated? That could increase probate and executor fees, and delay the payment of proceeds as they will be tied up in the administration of the estate. It could also expose the insurance proceeds to their creditors on death.

11. What is the purpose of the joint insurance policy? Might it be used to fund a Henson Trust or other trust to preserve Bill's rights to benefits or provide him with some financial security? Is its purpose to fund any tax liability that will arise on the last to die of Penny and Nicholas?

12. What are the details of the insurance policies – type of insurance (term, whole life, universal life), premium costs, adjusted cost base, cash surrender value?

13. If there are probate fees in the province, are they interested in probate fee planning? They would qualify, for example, for alter ego or joint partner trusts. However, the value of the assets appropriate for such planning is probably too little. Nevertheless, some probate fee planning might be appropriate, such as joint investment accounts, and beneficiary designations for registered plans and insurance.

14. How do they want their children to benefit from their estates? Their existing Will provides for equal shares – is this still what they want? It is important to ask how parents see their children inheriting their wealth – each of their children are in quite different situations, and asking this open-ended question ensures that the "equal" division is not just "rubber stamped" by the advisor.

15. Are they interested in creating testamentary trusts for their children to protect their inheritance from the claim of a spouse or common-law partner? Such family trusts could protect an inheritance especially if the child would likely combine the inheritance with family assets or put it in joint names with the spouse thereby losing any protection for an inheritance under provincial law (not in Quebec).

16. Are they interested in using testamentary family trusts for their children and their families to income split on a discretionary basis among other family members who are in the lower marginal tax brackets, such as their children or grandchildren or a low-income spouse of a child or grandchild?

17. What is the tax cost (ACB or adjusted cost base) of the home, cottage and other capital property?

7.2.2 Case Study 2: The Greenbacks' Estates

1. Dime can renounce as executor without court approval if he has not already started to act as executor. Once he takes action as an executor under the Will, such as having assets transferred, he can only resign with court approval and will likely be required to pass accounts. For Loonie to act as administrator, Dime must formally renounce in writing and file

the renunciation with the court, and Loonie must apply to the court to be appointed. Because she was not named in the Will as an executor or alternate she may be required to post security adding to the costs of the estate. She will also be required to demonstrate to the court that she is an appropriate person to be appointed, and if others contest her application or file competing applications, the process could be costly, unpredictable, and time consuming. Since Loonie is concerned about the time required and the possible difficulties with the beneficiaries, she may want either to have a trust company act as agent for executor, or have a trust company appointed either alone or along with her as co-executor. If she is co-executor or uses a trust company as agent for executor she will not have to do all the administrative work. If she is co-executor, she will still be involved in all decisions, but the trust company can take on the burden of fielding demands from beneficiaries.

2. The RRSP will be received without any withholding tax in Loonie's hands. However, the $68,000 will be included in Penny's "terminal" tax return. Loonie will not have any additional tax to pay as a result of being the beneficiary unless the estate does not pay the tax, in which case Canada Revenue Agency could require her to pay the tax.

3. Nicholas died first. His $35,000 registered plan will be paid to Penny's estate since she was the designated beneficiary and she was alive on his death. The full amount will be paid without any withholding tax as there is no withholding tax on funds paid from an RRSP when paid out as a result of the death of the annuitant. In the normal course, a rollover is possible if the funds are contributed to the plan of a surviving spouse. Further, if the spouse makes the contribution to his or her own plan, the personal representative must deduct the proceeds from the terminal return. (If the estate were the beneficiary this would have to be a joint election with the personal representative and the spouse.) However, since Penny died shortly after Nicholas, and did not contribute the plan proceeds to her own plan, no rollover took place, and even if Penny had contributed them to her plan, the proceeds would be taxed on her death in her final return. Nicholas' personal representative would have to decide in which final return the income from Nicholas' plan should be included to achieve the best tax result and make the election to deduct, or not, accordingly. Both of Penny's RRSPs will be paid to her estate

since Nicholas, the named beneficiary, died first. These plans will be taxable in Penny's terminal return.

4. Assets subject to probate:

Asset	Penny (dies second)	Nicholas
Residence (survivorship)	$425,000	
Bank Accounts	$10,000	
Bank Account (survivorship)	$35,000	
Life Insurance (no beneficiary)	$125,000	$300,000
Life Insurance (no beneficiary)	$200,000	
Registered Plans	$230,000	
Registered Plans	$68,000	
Registered Plan from Nicholas	$35,000	
Investment Accounts	$640,000	$800,000
Cottage (in Ontario)		
TFSA	$11,500	$20,500
Total for Nicholas' Estate		**$1,120,500**
Net value of Nicholas Estate	$1,020,500	
Total for Penny's Estate	**$2,800,000**	

The value of assets subject to probate could have been reduced if there had been a named beneficiary for the insurance (e.g., the designation could have been in favour of each other). Since they are both 65 or older, they could have sheltered probate on the investment accounts and the home by using alter ego trusts, or joint partner trusts. If the cottage is still part of Penny's estate because the joint title was not a true gift to Loonie then the value of the cottage would also be included in Penny's assets subject to probate. However, if it was intended that Loonie receive the cottage outright on the death of both her parents then it is not part of either of their estates and is not subject to probate.

5. The value of Penny's estate before expenses from question 4 is $2,800,000 and expenses are $395,200. The distributable estate is the net amount or $2,404,800. Estate expenses are calculated as follows:

Description	Formula (where applicable)	Expense
Probate Fees	1% of $2,800,000	$28,000
Funeral Expenses		$10,000
Real Estate Commission	5% of $425,000	$21,250
Executor's Fees	5% of $2,800,000	$140,000
Accounting and Legal		$11,950
Tax on Gain on Cottage	50% of (value less cost) x 50% inclusion rate for capital gains x 35% tax rate = ($92,500-$72,500) x 50% x 50%	$5,000
Tax on Penny's Two Registered Plans	$298,000 x 35%	$149,000
Tax on Capital Gains	one half $120,000 x 35%	$30,000
Total Expenses		**$395,200**

Note that even though the cottage is not part of the estate, the one-half interest Penny held at death is taxable. The other portion of the gain should have been reported when Loonie was added as a joint owner.

6. Since there are three children who share the estate equally, each child will receive one third of $2,404,800 or $801,600.

7. If Loonie died before her parents, 100% of the cottage would be in Penny's estate since Penny would be the last to die of the three joint owners. The $68,000 RRSP would also be in Penny's estate. Thus the value of assets to be distributed under Penny's Will would increase by $185,000 plus $68,000 or $253,000. The total value of the estate would be divided in three, one third to Bill, one third to Toonie. The remaining one third that would have been received by Loonie, had she survived her parents, would be divided equally among her three children.

8. The effect of a hotchpot clause for the cottage would reduce the amount of distribution to Loonie from the estate and increase each of her brother's and sister's shares so that when the value of the cottage is included, each of the children receive an equal amount. The existence of such a clause in the Will might also be considered evidence that the value of the cottage was intended to pass to Loonie on her parents' death and that it should not be included in the value of Penny's estate.

9. Loonie should review her own estate plan to consider if any changes should be made in light of her separation. Depending on the province and the period of separation, any appointment as executor, gift in the Will and appointment as attorney to a spouse may be no longer valid (although the more likely scenario is that they are still valid, necessitating a change to her documents). She should also review all beneficiary designations to ensure they are still appropriate. With respect to her inheritance, Loonie should get family law advice. In most provinces there is exclusion for property received by inheritance if it is kept separate from family property or can be traced to the inheritance. She should ensure that the funds from the inheritance are not mixed with other family assets so they do not lose their protection, although the fact that the separation occurred before the inheritance may exclude it from division in any event. Nevertheless keeping it separate provides the maximum protection as there can be no argument in the future as to the source of the funds.

7.2.3 Case Study 3: Loonie and Jack: The Next Generation

1. The gain on the cottage is \$600,000 less \$160,000 or \$440,000 of capital gains. If she sells the cottage in 2018, the maximum years she may claim the principal residence exemption is for the number of years in the holding period for which no exemption has been claimed on any other residence. So she may claim the exemptions for 2013 to 2018 or 6 years. She has held the cottage during 11 calendar years (2008 to 2018). The formula for the amount of exemption she could claim is the capital gain multiplied by a fraction whereby the numerator is the number of years claimed *plus one,* and the denominator is the number of years in the holding period. The exemptions would be as follows:

$$\frac{(6+1)}{11} \text{ X } (\$600{,}000 - \$160{,}000) = 7/11 \text{ x } \$440{,}000 = \$280{,}000$$

So the capital gain to be reported in the return is \$440,000–\$280,000 or \$160,000. Of that, 50% or \$80,000 is a taxable capital gain included in income.

2. First, Loonie should be realistic about her children's potential use of the cottage and their desire to maintain it. If she transfers it to a trust for their benefit now, she will not be able to reverse this later as the property will be owned by the trust for the benefit of her children. If she does transfer it, she should make sure there is an arrangement for the maintenance of the property and a lease or other agreement that Loonie and Jack can continue to use the property. She should consider discussing the future use of the cottage with her children. If she is not certain, she should wait. As can be seen from question 1, above, a sale of the cottage would result in a capital gain. A transfer to a trust would also be considered a sale at fair market value. If she is concerned about the taxes on death if the cottage is to be transferred then to the children, she could take out life insurance to fund the tax liability. In some situations where the children want the property, the children pay the premiums on the insurance.

3. Jack might consider creating a trust for his mother to fund the assistance he is providing on a pre-tax basis. There is no attribution for a trust for the benefit of an adult who is not a spouse. The capital in the trust could be payable to his mother at lower marginal rates, assuming she is in the low tax brackets. If he is a trustee he should be one of three trustees with a majority rule clause, and also he cannot be a capital beneficiary of the trust or the trustee attribution rule would apply to attribute all income gains and losses back to him. However, Loonie or his children could be the beneficiaries after his mother died. Jack could just give his mother money to invest, but then he would have no control over the funds, or how they are distributed when his mother dies. An attribution rule might apply to a loan if it was made for the purpose of income splitting. Jack should also make sure his mother has granted Powers of Attorney and made her own Will. If Jack is an attorney or executor, he should ask to obtain a copy of the documents and request information about the whereabouts of the original documents. He should also review the documents with his mother so he can ask for clarification about her wishes if required. Jack should make sure that his Power of Attorney for Property permits continued assistance to his mother.

4. Jack should make sure he provides for his illegitimate son in his Will. Failure to do so might give rise to a dependants' relief claim. He might consider an inter vivos trust for this child, but the attribution rules will apply on income (not capital gains) until the child turns 18. So an inter vivos trust would probably not be advised, as Jack can continue the voluntary payments during his lifetime. He might also include a direction in his Power of Attorney for Property to make sure the voluntary payments are continued by his attorney if he becomes incapable.

5. Since Loonie and Jack want to preserve capital for their children in the event the surviving spouse remarries, it is best not to make the spouse the direct beneficiary. They could make the children the beneficiaries omitting the spouse altogether. However, this may expose the estate of the first to die to a claim for division of property under family law, and/or a claim for dependants' relief. Also, they wish to provide for the surviving spouse while still protecting the children's interests. A spousal trust is one solution. It can be designed to achieve a rollover for income tax purposes if created in the Will, and during the lifetime of the surviving spouse all income is payable to the surviving spouse and no person other than the surviving spouse is entitled to capital. The children could be the beneficiaries on the death of the surviving spouse. There is no guarantee that the trust arrangement would protect the estate from a spousal claim, but as it would be more generous than disinheriting the spouse altogether it would reduce the risk of a successful claim. Trusts for the children may be beneficial if additional family members are discretionary beneficiaries along with the child so the trust can be used to income sprinkle among family members in lower tax brackets. Note that they have kept their assets separate, which is consistent with funding a testamentary spousal trust on the first death, and a set of children's trusts on the second death. Trusts for children might also protect the children's inheritance from the claim by a child's spouse in the event of marriage breakdown or death.

6. Toonie needs estate planning and family law advice. Depending on the province, she may not be entitled to inherit Bert's estate if he dies without a Will because they are a common-law couple and their relationship may not be recognized. Although in most provinces she would at least be entitled to make a claim for dependants' relief, this is not the case in every province. Toonie may have a claim for equitable relief against Bert

and/or his estate in respect of her contribution to the cottage property that is in Bert's name. While Bert and Toonie's children would inherit a share of Bert's estate on intestacy, Sam may not. We are not told whether Sam has been adopted by Bert or whether Bert treats Sam as his child. If adopted by Bert, Sam would inherit the same as the other two children. If Bert has raised or treated Sam as his own child he may be considered as Bert's child for inheritance on intestacy but this would depend on the facts and the details of provincial law. Inquiry should also be made as to whether Toonie and Bert have Powers of Attorney for Property and Personal Care. Toonie should also be concerned about Sam's welfare if she dies. Her only asset is the house and it will pass to Bert by right of survivorship. This would leave Sam with nothing, although a claim could be made for dependants' relief. Provincial law may provide that jointly held property is available to satisfy such a claim even if it passes to a third party.

7.2.4 Case Study 4: Big Banana

1. Based on the information given, the value of BB Holdco is $8,000,000 plus $1,500,000 for $9.5 million. At present the investments in the holdco, which are not used in the active business, exceed 10% of the value of the other assets in the group. Thus the shares of BB Holdco are not qualifying shares of a small business corporation. The value of assets used in the active business carried on primarily in Canada must be 90% of the value of all assets at the time of the sale. (Note: there is a relieving provision in the case of death where a time period after death permits the estate to bring the corporation within the 90% test.) There is also a 24-month holding period required prior to the transaction that we are told is satisfied as the siblings have owned the shares for 10 years. During the 24-month holding period a 50% test is also applicable that requires 50% of the value of the assets to be used in the active business throughout the period. Assuming this last test is satisfied, it may be possible for them to "purify" by extracting assets from BB Holdco tax free into a separately held corporation. Alternatively, they could use the funds in the holdco to purchase business assets, or pay salary or dividends to reduce the value of the non-business assets to 10% or less of the value of all assets.

2. Often the profits of an operating company will be pushed up to a holdco by way of a tax-free inter-corporate dividend to protect them from the creditors of the business.

3. Corporate-held insurance will be better than individually owned policies because the after-tax dollars used to fund the premiums will be cheaper from within a corporate vehicle. Funds paid to the individual shareholders to pay the premiums from the corporation will be taxed in the hands of the shareholder as a dividend, salary or a bonus. As between BB Holdco and BB Ltd, it might be best to use Holdco to hold the insurance. In the event BB Ltd is sold to an arm's length party in the future, the insurance policies cannot be extracted from the corporation without possible tax consequences.

4. The estate freeze:

   (a) As mentioned in 1 above, the shares of BB Holdco will have to pass the 90% test and transactions will have to be completed to achieve this, either by way of a purification corporate reorganization or otherwise. It may be necessary to have the business value appraised to support the numbers used in applying the 90% and the 50% test. The value of the assets of the last 24 months will also have to be reviewed to ensure that the 50% test is satisfied.

   (b) A freeze could be effected either at the holdco or opco level. However, it might better facilitate future use of the capital gains exemption by the new common shareholders to do the freeze at the opco level and freeze BB Holdco's interest in BB Ltd, and issue new common shares of BB Ltd. This would also permit the siblings to benefit from the future growth of the portfolio in holdco, but not the value of the business carried on by BB Ltd. If the sibling shareholders can purify BB Holdco, they may want to crystallize their capital gains exemption as part of the freeze, and this would have to be done at the holdco level since only an individual may claim the capital gains exemption. In this case new common shares of BB Holdco could be issued, in which case the siblings would be giving up the future growth in value of both the business and the portfolio. Alternatively, there could be a crystallization by the siblings that is not a freeze, and the freeze could still take place at the BB Ltd level.

(c) The shares could be issued to a family trust, or directly to the children. In most cases parents want to continue to exercise a degree of control over the shares, and defer the decision as to the actual succession of the business as among their children. Here we have three siblings. To permit each sibling to control the interest of his or her children separately, three separate discretionary family trusts might be created. The trusts could also permit income sprinkling among adult beneficiaries. It might also be possible to include each sibling as a discretionary beneficiary in the trust, if the trust is properly structured and funded. In addition to the children, the children's spouses and other issue could be discretionary beneficiaries.

If the children are adults, the shares could be issued directly to the children, assuming Edna and her sister and brother are comfortable with this. This would be something they should consider carefully both as between each of them and their children and as between themselves. A shareholders' agreement is always recommended in such a situation, particularly where there are partners in the business and it is not owned by a single family member or a married couple. Each sibling should be protected from the other sibling and from their own children and their nieces and nephews.

GLOSSARY

Abate: The reduction of gifts in a Will to satisfy debts and other expenses of the estate. The residue is exhausted first, then general gifts, then specific gifts other than real property, and last specific gifts of real property. Abatement has a similar meaning.

Adeem: A gift is said to adeem where the property gifted is no longer owned by the testator. For example, a gift of "my red Porsche" will adeem if the testator no longer owns a Porsche at the time of death. Ademption has a similar meaning.

Annual Gift Tax Exclusion Amount: The amount that can be gifted annually to any particular recipient, without attracting U.S. gift tax.

Cash Surrender Value (CSV): The amount, if any, available in cash upon surrender of a life insurance policy during lifetime of the insured, after all charges are incurred (i.e., some policies may impose surrender charges for early cancellation of a policy). Many policies, such as term insurance policies, do not have CSV.

Cash Value: This term is sometimes used interchangeably with CSV. However, it is also used to refer to the amount of the death benefit that exceeds the face amount; amounts attributable to dividends paid (and that during lifetime of the life insured are reflected in the CSV); or the value within the policy before surrender charges are applied.

Crystallization: A transaction whereby the capital gains exemption on qualifying property is realized for tax purposes only by incorporating the amount of the exemption into the cost base of the qualifying property. The owner of the property does not change, and generally proceeds are not received by the individual owner (although in limited circumstances non-share consideration may be received but the amount that can be received is restricted by the *Income Tax Act*). The purpose is to boost the tax cost of the property by the exemption in the event the property does not qualify for the exemption in the future.

Death Benefit: The amount payable from a life insurance policy to a named beneficiary as the result of the death of the life insured. For many permanent life insurance policies this includes the face amount and any additional amount attributable to the cash value of the policy.

Estate Freeze: A transaction whereby property of an individual is fixed in value but the value of the future growth is transferred on a tax-neutral basis to the persons who will inherit the property.

Executory Trust: A trust that is created outside the Will on the death of an individual. Such trusts are usually set up to be funded with life insurance proceeds on the death of the life insured.

Face Amount: The amount insured under a life insurance policy. It generally represents the amount of risk assumed by the life insurance company. It does not include other amounts such as policy dividends or cash value payable in excess of the face amount on the death of the life insured party. The face amount may also be referred to as the "sum insured."

Guaranteed Cash Surrender Value: That portion of the cash surrender value of a life insurance contract that is guaranteed and is usually set out in the terms of the contract. The guaranteed cash surrender value does not include such variables as reinvested dividends. Only certain types of policies have guaranteed cash surrender values.

Hard Facts: Facts relating to a client's personal and financial affairs that are objective and can be verified with documentation or third parties. A client's date of birth or the value of the vacation property are hard facts.

Hotchpot: An adjustment clause, usually in a Will, that requires the inclusion of the value of other property from outside the estate to be added into the calculation for the purpose of determining the share of a particular beneficiary. For example, if the estate is worth $180,000 and is to be divided equally among three children, the share of each child would be $60,000. But suppose one child has already received insurance proceeds outside the estate of $30,000? A hotchpot clause in the Will requires the insurance to be brought into hotchpot in respect of that child's share and will result in that child receiving only $40,000 from the estate and the other children receiving $70,000 each. This has the effect of equalizing each child's benefit arising on death since each child will have received a total of $70,000, whether from inside or outside the estate passing under the Will.

In Kind: Refers to a transfer to satisfy a gift made by transferring property equal to the value of the required gift rather than in cash. For example, if the Will required a gift of $1,000 to a grandchild, and the Will permitted gifts to be

satisfied in kind (sometimes referred to as "*in specie*") the executor could transfer a Canada Savings Bond bearing interest at current market rates with a face value of $1000 in lieu of making a cash gift. Similarly the residue of the estate could be distributed in kind from the assets of the estate without converting the property owned at death into cash.

Inter Vivos: During lifetime. Refers often to gifts made during lifetime or trusts created during lifetime as opposed to those on death.

Intestate: To die without a Will.

Issue: Lineal descendants related by blood or adoption – i.e., children, grandchildren, great-grandchildren. Step-children are not included unless legally adopted. Illegitimate children or other issue are included.

Life Insured: The person whose life is insured under the life insurance policy. There could be more than one life insured, such as with a joint last-to-die policy or multi-life policy.

Lifetime Gift and Estate Tax Exemption Amount: The value of an estate that will not be subject to U.S. estate tax. The exemption amount is the basis for calculating the unified credit. The unified estate tax credit, whether the full amount which is available to U.S. persons or the pro-rated amount which is available to non-resident aliens, will always offset all the U.S. estate tax on an estate with a worldwide value equal to or less than the Lifetime Gift and Estate Tax Exemption Amount in the year of death.

Marital Deduction: The deduction available under U.S. domestic law for the first to die of a married couple where both are U.S. citizens or other persons taxed as U.S. taxpayers, including U.S. citizens or U.S. Green Card holders. The deduction defers the U.S. estate tax on any amount left to the surviving spouse or certain spousal trusts, until the death of the surviving spouse. Married Canadians who are both non-resident aliens may only benefit from the marital deduction if the property is left for the benefit of the surviving spouse in a Q-DOT and no marital credit is claimed.

Net Cost of Pure Insurance (NCPI): This refers to the mortality cost as determined under the Income Tax Regulations. The NCPI is relevant for determining a policy's adjusted cost base, and for calculating the deductible amount of premiums where a policy is assigned as collateral for loans.

Non-Resident Alien: A person who is not a citizen of the U.S., or who is not otherwise a U.S. taxpayer. Under U.S. gift and estate tax law, residency is based on where an individual is "domiciled." The concept of "domicile" is different than residency for income tax purposes. A non-resident alien for gift and estate tax purposes is not a U.S. citizen, or a U.S. Green Card holder or foreign person who is "domiciled" in the U.S.

Per Capita: A distribution that is equal per person no matter what the relationship to the deceased.

Permanent Insurance: Insurance that continues for the life of the insured. Whole life and universal life are the two most common examples. These policies have a face amount and may also have an additional value that accumulates based on certain reserve calculations and investments of the premiums not required to fund the current cost of insuring the face amount. Over time the value of the CSV or cash value on death can exceed the face amount, although this is not typical.

Policy Owner: The person who has legal ownership of the policy and who has the right to designate a beneficiary. Change of ownership is a disposition for tax purposes and any gain or loss is not a capital gain or loss, but an income account.

Proponent: the person who is supporting the validity of a position or document. In reference to a Will, it refers to the party seeking to have a Will probated, and who is asking the court to formally approve of the Will.

Purification: A transaction whereby the assets in a corporation are altered so that 90% of the value of the assets in the corporation (or in the corporate group where there is more than one corporation) is used in an active business carried on primarily in Canada. Usually this is accomplished by a corporate reorganization whereby non-qualifying assets are stripped out on a tax-deferred basis to a corporation held separately by the individual shareholders.

Qualifying Spouse Trust: A trust settled for the benefit of the settlor's spouse whereby during lifetime of the spouse all the income (but not necessarily capital gains) is payable to the spouse and no person other than the spouse may have any right to the capital of the trust. There is a rollover available for capital property transferred to a qualifying spouse trust either during lifetime of the settlor, or to a qualifying spouse trust established under the terms of the Will.

Quantum Meruit: An equitable remedy that awards compensation for the value of services provided gratuitously.

Resident Alien: For U.S. income tax purposes, this includes a U.S. Green Card holder or a foreign person who meets the substantial presence test but who has not claimed a closer connection exception (not available for U.S. Green Card holders) or a treaty exemption. For gift and estate tax purposes, this includes U.S. Green Card holders and foreign persons who are "domiciled" in the U.S.

Soft Facts: Information relating to a client's views, judgments, wants, and philosophy that are subjective to the client. The fact that a client is concerned about the potential claim of a difficult son-in-law, for example, is a "soft fact." Soft facts often influence a client's objectives.

Term Insurance: A life insurance policy that covers a specific period, such as one or more years, after which the insurance expires. It pays a death benefit equal to the face amount if the life insured dies during the term, although there may be additional benefits or riders, such as conversion rights, and options for additional terms. It has no CSV and is the cheapest form of life insurance over the short term. Over the longer term, however, term insurance can become extremely expensive. For this reason it is recommended for short-term insurance needs, but not for the permanent needs that frequently arise in an estate planning context.

Testamentary Trust: a trust created as a result of the death of an individual, usually in a Will. Executory trusts are also considered testamentary trusts.

Unified Estate Tax Credit: The amount of the U.S. estate tax that can be sheltered by the Lifetime Gift and Estate Tax Exemption Amount. A U.S. citizen or resident alien will be able to claim the full amount, but a non-resident alien is entitled to a pro-rated amount based on the proportion of the value of the deceased's estate, which represents U.S.-situs property.

U.S. Citizen: An individual who has U.S. citizenship. A person born in the U.S. or a person who is born to a U.S. parent in a foreign country may have U.S. citizenship.

U.S.-Situs Property: For the purposes of the U.S. rules this is property that is subject to U.S. estate tax and U.S. gift tax for persons who are non-resident aliens of the U.S. Certain intangible U.S. property is U.S. property for the purposes of U.S. estate tax, but not for the purposes of U.S. gift tax.

U.S. Taxpayer: An individual who is a U.S. citizen or U.S. resident alien for U.S. income tax purposes.

Universal Life Insurance Policy: A life insurance policy in which premiums (less expense charges) are credited to a policy account from which periodic charges for life insurance coverage are deducted and to which interest or investment earnings are credited. Policy owners are able to choose from a variety of investment accounts. Usually the policy owner can vary the amount and timing of premium payments and change the amount of insurance (subject to underwriting).

Advanced Estate Planning

COURSE 257

2017 EDITION

This course draws upon the technical knowledge and expertise developed through the preceding CLU courses. Rather than just technical details, emphasis is placed on the application of the knowledge gained in the other courses and the planning process. The program is designed to assist financial advisors in identifying problems, gathering comprehensive data and planning integrated solutions, essential components in their clients' financial and estate planning. Advanced Estate Planning is Course Seven of a seven course program in the CLU designation program.