Aging Boomers up the Estate Planning Ante – Part I

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I remember where I was when Kennedy was shot; I watched the Beatles live on Ed Sullivan. Even so, I bristle when I see ads pandering to me and my fellow Boomers with old recordings fit for 8-tracks, not iPods. But when I saw a recent issue of a legal magazine featuring estate planning for greying Boomers, things began to sink in: when it comes to inheritances, we are rapidly going from the receiving end to the giving end.

But the usual estate planning content – updating your will, doing a power of attorney, a reverse mortgage here and there - misses a big point, namely that the demise of the older generation will involve the greatest wealth transfer in history (and there will be more than chump change left over when we Boomers ourselves leave the building).

Trouble is, this enormous wealth transfer is converging with an increasingly complex legal environment, particularly in the income tax area. This article presents some estate planning issues that will become increasingly important as wealthy Boomers age. As will be seen, the issues in play go far beyond traditional estate planning considerations.

U.S.Emigration

My generation and those which follow have unprecedented mobility, especially to south of the border. If the emigrant is from an affluent family, it is possible, if not likely, that he or she will have an interest in an investment-type company, perhaps real-estate related or the holdco of an operating company which has generated excess cash. Whether the interest is direct or indirect (e.g., through a family trust), the U.S. CFC and PFIC[i] rules, pertaining to "passive" income earned by foreign corporations, potentially come into play. Often, there will be harsh U.S. penalties, onerous reporting requirements and the like.

Until a few years ago, there was very little written on this. But the issues have gradually sunk in. Many of the physicians who went to Texas years ago are now aging Boomers; and new problems will arise from the U.S. high-tech companies now grabbing young Canadian graduates. Soon we Boomers ourselves will start to relocate to the sunbelt, along with our shareholdings - hand in hand with serious U.S. tax consequences to the unwary - not to mention the serious *Canadian* consequences stemming from ceasing to be resident: the departing shareholder must either cough up capital gains tax on the shares or furnish acceptable security to the CRA.

Whether the family member has gone to the States or elsewhere, the distribution of shares and most other assets from a family trust is now a taxable event based on the value of the shares at the time of distribution – whether or not the shares are taxable Canadian property.[ii] Tax on distributions to U.S. residents can be deferred by a distribution to an unlimited liability corporation rather than the U.S. resident. It may be prudent to draft new trusts with this procedure in mind.

Canadian Beneficiaries of Trusts and Estates

The transfer of wealth to Canadian Boomers may be from abroad. If a Canadian is a beneficiary of a non-resident trust (including an estate), the foreign investment entity (FIE) proposals potentially apply.[iii] If applicable, these proposals typically impose an income inclusion calculated by applying an imputed interest charge (currently 7%) to the "designated cost" of the interest in the non-resident entity. The FIE proposals include an exemption for trusts which are completely discretionary; however, most discretionary trusts include "fail safe" clauses, which specify pre-set allocations/distributions, that are operative in the event of a failure to exercise discretion.[iv] A recent article in an Ontario Bar Association tax section newsletter**[v]** alludes to an example where a lone Canadian resident is one of many beneficiaries of a large *inter vivos* trust established, say, in Hong Kong. If there are no other Canadian beneficiaries, the usual FIE calculation may necessitate applying the deemed interest rate to the "designated cost" of the trust, which can be based on the trust's entire gross assets.[vi] And as I indicated in a fairly recent article,[vii] similar rules also apply to a Canadian beneficiary of a non-resident estate.[viii]

Also, as a result of the non-resident trust proposals, transactions between a Canadian resident and a non-resident trust/estate - even if indirect - must be reviewed very carefully. Various deemed contribution provisions may result in the trust being taxed like a Canadian resident – e.g., on its worldwide income[ix], if there is a "resident contributor".

As can be seen from the foregoing, advising a Canadian beneficiary of a non-resident trust or estate may require nothing less than a detailed knowledge of the non-resident trust and FIE proposals - some of the most complex legislation around.

Deemed Disposition Rule – Twists for Generation Xers

The fact that there is a deemed disposition of shares and other assets passing to another generation is nothing novel (although the amount of taxes collected from this rule in coming years may be). What may change is the *post-mortem* planning strategy that may be best. In the past, the tax resulting from the deemed disposition rules was looked at as a wasted expense, especially where the underlying assets, e.g., the family business, would continue to be held by the next generation.

But is it? The affluence of recent years has changed attitudes, particularly the offspring of wealthy Boomers. The spectre of carrying on family businesses is often looked at as a burden rather than a

privilege; instead, there may be increasingly more motivation to seek a more enjoyable life style, funded by family wealth. Where this is held at the corporate level, there will be more pressure to extract these assets, to fund lifestyle choices. In these circumstances, the deemed disposition rules may not result in the "wasted tax" that they might have been a generation ago: the terminal-period capital gains tax could be an efficient way to tax-pay future distributions of cash and other corporate assets in order to meet these objectives. Along the same lines, practitioners should determine whether a corporate-level sale of the family business or other assets is in the cards. If so, techniques which involve the bumping of cost base as part of a *post mortem* procedure may be attractive, especially if a capital dividend account or refundable tax is generated, as these tax accounts will allow tax-efficient distributions.

Continued next month..

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[i] Respectively: "controlled foreign company" and "passive foreign investment company".

[ii] See subsection 107(5).

[iii] See the definition of "specified interest" in proposed subsection 94.1(1). Of course, the trust must be a foreign investment entity to begin with. Notably, this would not be the case if the trust did not run afoul of the tests in paragraphs (b) and (c) of the "foreign investment entity" definition, pertaining to carrying value of investment properties or "principal business". However, most trusts/estates would meet these tests.

[iv] Another possible avenue of temporary relief is the "successor beneficiary" exception, whereby income or capital can be received only after the death of an individual who is a contributor to the trust, or in circumstances where the individual may be related to the contributor.

[v] "Discretionary Trusts and the FIE Rules", James W. Murdoch, *Taxation Law*, Volume 17, No. 2, Ontario Bar Association. As stated in the article, the previous round of revisions exempted trusts where all amounts depend on the exercise or *failure to exercise* discretion. The latest revisions delete failure to exercise, which is the precondition for clauses which stipulate "fail safe" allocations/distributions.

[vi] As the article indicates: "there is a special rule for determining the designated cost of trust interests that effectively gives the holder of the interest a designated cost equal to the trust's cost amount in its property (other than "restricted property") plus the fair market value of any restricted property. This amount is then divided by the number of Canadian-resident beneficiaries who similarly hold a participating interest in the trust and who are identified by the taxpayer in prescribed form." See proposed subparagraph 94.1(2)(c)(ii). There are a number of ambiguities and anomalies in this provision, which I will not discuss in this article.

Proposed paragraph 94.1(2)(c) deems designated cost to be the greater of this amount and the designated cost otherwise determined. In the case of an interest in a trust or estate, clause F (or D) of the proposed "designated cost" definition in subsection 94.1 would typically apply, so that, but for proposed subparagraph 94.1(2)(c)(ii), the designated cost otherwise determined would be based on the fair market value of the beneficiary's interest.

[vii] "Heartbreak Hotel – Foreign Estates and The FIE Rules", by the author, *Tax Topics* report #1751, September 29th, 2005.

[viii] The definition of "trust" in proposed subsection 94.1 indicates that "trust" includes, for greater certainty, an estate. The definition of "exempt interest" is to be expanded to include a participating interest in a non-resident entity if the non-resident entity is, during the period in its taxation year that the taxpayer held the participating interest, a testamentary trust that is an estate that arose on and as of a consequence of the death of the individual, and the particular time is no more than twelve months after the death of the individual. The twelve month period can be extended by the Minister.

[ix] See “NRT Rules: Harsher Than You Think”, by the author, *Tax Topics* #1705, November 11, 2004. For a detailed discussion, see “Observations on Section 94”, by William Innes and Dessislav Dobrev, 2006 AC No. 36, which includes a list of transactions with a non-resident trust. Proposed subparagraph 94(3)(a)(iv) provides that a trust subject to (proposed) section 94 is resident for the purposes of proposed section 94.1 and is therefore excluded from the definition of “non-resident entity” in proposed subsection 94.1(1).