



BDO Dunwoody LLP
Chartered Accountants
and Advisors

Tax Bulletin

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Estate Planning

Like most people, you have definite goals, both personal and financial. However, without a plan to focus your efforts, it will be very difficult to achieve them.

This bulletin is designed to get you thinking about estate planning and how it can apply to you. Estate planning is a very wide-ranging topic; you need to concentrate on the various components of a good estate plan and how they apply to your personal situation and goals. Once you've read this bulletin and considered the topics that we are going to introduce carefully, contact your BDO advisor to begin the process of establishing an estate plan that makes sense for you.

Even if you already have an estate plan in place, keep reading. Estate planning is a continuing process. At different stages of your life, your personal situation and goals will change, and you will want to update your estate plan. An effective estate plan is one that you constantly monitor to ensure that it continues to be relevant for you.

Objectives of estate planning

Estate planning has many objectives. Simply put, the goals of estate planning are to:

- ◆ Maximize the value of your assets, including the preservation and protection of property during your lifetime;
- ◆ Minimize and defer tax and other costs arising on your death;
- ◆ Allow for an orderly transition of assets to your beneficiaries; and
- ◆ Provide for your dependants, which can include decreasing their taxes where possible.

You will likely have many other objectives, as well. For example, you may want to leave specific assets to certain beneficiaries while treating beneficiaries fairly. Or, you may want to make a sizeable gift to charity on your death.

Due to the wide variety of possible estate planning objectives, estate planning has often been described as an art rather than a science—there are few general rules that will apply for all individuals. In addition, some of your goals may come in conflict with others. For example, if the majority of your net worth is represented by an investment in a family business, it may be difficult to treat all children equally while transferring your business to one child as your successor. Also, minimizing tax is an important objective for most individuals, but you also have to make sure tax minimization strategies do not conflict with your other objectives. Therefore, estate planning is a balancing act and you'll need to evaluate these conflicting issues and choose a plan that makes the most sense for you. Ultimately, an effective estate plan will address as many of your individual goals and wishes as possible.

When developing your estate plan, don't focus only on your beneficiaries; think about yourself and the income and assets you'll need to enjoy the lifestyle that you want. A good estate plan will ensure that you have saved adequately for your retirement, either by contributing to your Registered Retirement Savings Plan (RRSP) or other pension plans, or through other savings. You don't want to plan to give away assets and then realize later that you really need them for yourself.

A good estate plan will also help your family with the burden of dealing with your estate at a very difficult time. This will mean that they will not have to deal with potentially difficult legal and tax matters. Your family will have enough to deal with when the time comes, so it is important to deal with major decisions prior to death.

One final thing to keep in mind is the importance of discussing your plan with your family. Too many people assume that their family understands their goals and objectives concerning estate assets. Estate planning works best when your family is aware of your plans and understands why certain decisions were made.

Estate planning for family business owners

As mentioned earlier, if you own a business and you intend to turn the business over to your children, even more planning is involved. You are not only passing on ownership of the business, you're also providing for management succession. Generally speaking, unless you plan ahead for succession, your business will not maintain its value when ownership passes to your heirs.

In some cases, the business may not even survive, or it may have to be sold off. Given the importance of this issue for family business owners, we have prepared separate bulletins – *Succession Planning for Family Business* for business owners in general and *Succession Planning for the Family Farm* for agricultural businesses.

Maximizing the value of your estate

There are a number of steps you can take during your lifetime to maximize the value of your estate, by increasing the net cash that flows to you, and by minimizing possible threats to your estate. In the rest of this section, we describe simple strategies you can use to maximize the value of your estate during your lifetime.

Pay down personal debts

If you're like most people, you'll have to borrow to buy an expensive asset, such as a house. One of your first goals should be to pay down these personal debts. From a tax perspective, paying off personal debt is an excellent way to save money.

Let's assume you have a \$200,000 mortgage at a 3% interest rate (we'll ignore compounding interest to simplify matters). At the end of each year, you have the option of paying off 15% or \$30,000 of the principal. If you make the extra mortgage payment, you will reduce your interest costs in the next year by 3% of \$30,000 or \$900. If you invest the \$30,000 in a term deposit that earns interest at 3% instead of paying down your mortgage, you will also earn \$900 in interest.

What's the difference? Since the mortgage was taken out to buy a non-income producing asset (your home), you can't deduct the interest expense for tax purposes. If you pay down your mortgage and save \$900 in interest costs, you'll be \$900 ahead at the end of the year. However, if you earn interest on a term deposit of \$900, you will have to pay tax on this income. If your marginal tax rate is 45%, you'll really have only earned \$495 of interest after taxes. You would have had to earn interest at a rate of approximately 5.5% or \$1,636 on your term deposit to put you in the same after-tax position.

Properly managing personal debts is one of the best ways to build your estate when you are acquiring assets.

Be vigilant about paying off these debts as quickly as possible.

Save for your retirement

It's never too early to start thinking about saving for your retirement. The earlier you start, the more you will have to enjoy when you decide to stop working. In addition, properly funding your retirement will increase the value of your estate available to be passed on to your family.

The Canadian tax system allows you to save for your retirement on a tax-deferred basis, either through a pension plan at work or through your own RRSP. Not only are the contributions to these plans deductible for tax purposes, saving you taxes now, but the income earned on contributions are not taxed until you withdraw them from your plan, which may not be for many years. These rules make pension plans and RRSPs the best tax shelters in Canada.

Take full advantage of your pension plan or RRSP to save for your retirement. If you have any questions with respect to RRSPs, see our bulletin entitled *Answering Your RRSP Questions*.

Another savings option was announced in the 2008 Federal Budget – the Tax-Free Savings Account or TFSA. Starting in 2009, Canadian residents age 18 or older will be eligible to contribute up to \$5,000 annually to a TFSA, with unused room being carried forward. This \$5,000 limit will be indexed for 2010 and subsequent years. Although contributions will not be deductible, the accumulated income will also not be taxed as it is earned in the plan or later, when it is paid out to you.

The TFSA may prove to be more flexible than an RRSP, as when funds are paid out of the plan to you, the payment will be added to your TFSA contribution room. You can set up a TFSA, save for a specific purpose (such as buying a house) and collapse the plan when you need the accumulated funds. Later, when you do have surplus funds, you can contribute again to an existing TFSA or a new plan. TFSAs can be used for various savings purposes, including retirement. In the case of an RRSP, once you contribute and later withdraw funds, that RRSP room is gone forever. Therefore, RRSPs remain a true retirement savings vehicle. For more information on TFSAs, see our bulletin entitled *Answering Your TFSA Questions*.

Split income with family members

The more tax you can save, the faster you will build the assets in your estate. If you can split income with family members who have lower marginal tax rates than you do, this will help reduce your income taxes.

Income splitting can be as simple as having your spouse save money while you pay all the family expenses (assuming your spouse has a lower marginal tax rate). Or, if you are already in retirement, you can elect to split CPP benefits with a lower-income spouse. Beginning in 2007, recipients of pension income eligible

for the pension credit can split up to ½ of that income with their spouse. More sophisticated plans could involve the use of a family trust.

To learn more about income splitting strategies that are appropriate for you, see our bulletin entitled *Income Splitting*.

Disability insurance

What would happen if you suddenly became permanently disabled due to an accident? Would your family have the resources to take care of you? Would the loss of your income mean undue hardship for your family, or wipe out the estate you intend to pass on?

Many employees have some form of disability insurance through work, usually structured so that any disability payments received would not be taxable. However, if you are a self-employed contractor, or have your own business, you may not have considered the financial consequences of becoming disabled.

Consider disability insurance if you are currently not covered. You'll need to determine the level of coverage you'll need in order to provide you with a sufficient level of income should something happen to you. In addition, carefully read the fine print, as not all disability policies are the same. For example, does the policy cover situations where you can no longer perform duties in your chosen occupation, or does it simply cover situations where you are unable to work in any occupation?

Protecting your assets from business risk

While it's difficult to fully protect your assets from business risk, you can take some steps to protect your assets from possible claims in the future. For example, even though RRSPs now enjoy protection under Federal bankruptcy law, RRSPs held with life insurance companies may still be safer from creditor claims than RRSPs held with other institutions such as banks (given limitations exist under the Federal bankruptcy rules). As another example, if you are a professional, it may make sense to have your spouse hold investment assets, as it is generally not possible for professionals to fully insulate themselves from professional liability even with the use of a corporation. These rules vary from province to province.

Powers of attorney

What happens if you lose the ability to manage your affairs and make important decisions? Who will take charge? You might be surprised by the answer. Although your assets will be protected, there will be a cost associated with dealing with the legal issues. In addition, as the legal issues are resolved, important financial decisions may not be made on a timely basis.

By drafting a power of attorney, you will be able to choose the person who is best qualified to manage your affairs should you become mentally incapacitated. A

power of attorney gives written authority to this person to deal with your estate on your behalf.

If you don't have a power of attorney, provincial laws will govern who is responsible for managing your affairs. Although interested parties can generally apply to the courts to be granted the right to conduct your affairs, this can be a time-consuming and expensive process. If you don't have a power of attorney, speak to your lawyer about getting one in place.

Family law considerations

Do you have significant assets and are about to marry or remarry? Will you be leaving significant assets to a child who is not yet married? If so, it is important to understand the family law rules that apply in your province. In many cases, a division of assets will be required in the event of marriage breakdown.

One way to reduce uncertainty and ensure that your assets are dealt with fairly for all concerned is a marriage contract. A marriage contract allows you and your spouse to agree beforehand on how your assets will be divided in the event of a marriage breakdown. For business owners and individuals with children from a previous marriage, this can be extremely important.

In addition, in some provinces, family law can also override the rules for property division contained in your will. Consequently, a marriage contract can also help ensure that your estate is divided as you intend on your death. Consult your lawyer to see whether you should consider a marriage contract.

Minimizing and deferring tax on death

Once you have ensured that you have maximized the size of your estate, the next step is to ensure that the tax on your estate is minimized. There are two basic types of tax that can arise on your death—income tax and taxes based on the value of your estate, such as U.S. estate tax and probate tax. In the rest of this section, we discuss how these taxes arise and steps you can take to reduce, or at least defer, these costs.

Income taxes arising on death

When an individual dies, they are deemed to dispose of most of their assets for tax purposes at their fair market value. For capital property, this means that all accrued capital gains will be taxed. If you own depreciable property such as a rental property, depreciation you claimed in the past will be included in your income assuming that the current fair market value of the property exceeds its original cost. The value of RRSPs and Registered Retirement Income Funds (RRIFs) is also generally included in an individual's income on death.

For most individuals, the tax arising on these deemed dispositions will represent the largest tax cost on death. Consequently, one of the main goals of estate planning is to minimize these taxes where possible. Also, once you've minimized the tax bill, the next step is to try to defer its payment for as long as possible.

Strategies to reduce income tax

When planning for taxes arising on death, tax plans usually fall into two categories—plans that reduce tax and plans that defer tax. Dealing with tax savings first, there are a number of ways you can reduce taxes that will arise on your death.

Claim Capital Gains Exemptions

If you own qualifying small business shares, qualifying farm property or qualifying fishing property, the \$750,000 capital gains exemption that can be claimed on the disposition of this property is an important estate planning consideration. If you own this type of property, there are two basic ways of using the exemption. First, your executors can simply claim your remaining exemption against capital gains that arise on your death. However, there are potential problems with this plan:

1. The property may not qualify at the time of your death, and
2. There is no guarantee that the exemption will always be available.

Consequently, you should consider the second option for using your exemption – a crystallization of some or all of your gain. A crystallization involves triggering a disposition of one or more qualifying assets with accrued capital gains for tax purposes. Any capital gain reported in your tax return will be offset by a capital gains exemption claim, meaning that you will generally not have any tax to pay. The benefit of the exemption will be realized in the future when you dispose of the asset, as it will now have an increased cost base for tax purposes which will reduce the capital gain you have to report on the actual disposition. If you haven't fully used the exemption and you have qualifying assets, consult your BDO advisor to see if a crystallization makes sense for you.

Make gifts to charity

If you're planning to give money to charity in your will (referred to as a charitable bequest), these gifts can be claimed to reduce income tax arising on your death.

Before dealing with the tax rules that apply specifically to charitable bequests, it is important to understand the basic rules. Charitable donations made by individuals are eligible for a non-refundable Federal tax credit. The first \$200 of donations are eligible for a 15% non-refundable credit while the excess over \$200 is eligible for a 29% credit. Provinces and territories also offer tax relief as separate credits against provincial or territorial tax. Consequently, the actual tax savings from charitable gifts will vary by province or territory.

There are also rules that limit the amount of donations you can claim during the year. Your donation claim will generally be limited to 75% of your net income for the year in which you make the gift. If you gifted capital property, you may be able to claim an additional credit amount, which will ensure that any tax from a taxable capital gain and recapture of depreciation that arose from that gift can be offset by a donation credit. If you make a large gift in a particular year and you can't claim the full amount, the unclaimed portion can be carried forward and claimed in the following five taxation years.

Due to the limitations on donation claims and the fact that donors must ensure that they provide for themselves and their family, many choose to wait and make large gifts under the terms of their will as a charitable bequest. To assist individuals making these gifts, the government has provided special rules for bequests and other gifts made in the year of death:

- ♦ **One-year carryback** – Donations made in the year of death can be carried back and claimed in the prior year. This rule will be especially useful where income in the year of death is low.
- ♦ **Income limitations waived** – In the year of death and the previous year, the 75% net income limitation discussed above will not apply. Your donation claim can be up to 100% of your net income, which will be more than enough to eliminate your income tax.
- ♦ **Charitable bequest carryback** – If you provide for charitable bequests in your will, the actual gift will be made sometime after your death. However, if certain conditions are met, your executors can claim this gift in the year of death on your final personal tax return. Using the general one-year carryback rule above, the bequest can also be claimed in the year prior to death.

Prearrange your funeral

Although not a pleasant topic, arranging for your funeral before you die will relieve your family of having to deal with these details at a very difficult time. In addition, you can also obtain a modest tax saving. You can give a funeral home up to \$15,000 for funeral services or \$20,000 for cemetery services on deposit towards the cost of the funeral, and the investment income earned on these funds will not be taxable to you. Where the funeral home is providing both funeral and cemetery services, the limit is \$35,000 in total. As long as the investment income is eventually used for cemetery or funeral services, the investment income will never be taxed.

Note that if the funds are returned to you, or if your estate receives a refund from the funeral home because the amount on deposit exceeded the funeral costs, these amounts will be taxed to the extent that investment income was earned.

Income tax deferral strategies

After you have minimized the potential tax cost, your next priority will be to try and defer this cost as long as possible.

Income tax can generally be deferred by transferring assets to family members or other beneficiaries who are younger than you, as they will also face a deemed disposition of their assets on death. A tax rollover will provide the largest deferral, as both past and future gains will be taxed in the hands of your beneficiaries. In the case of deferred income plans such as your RRSP, your beneficiaries will pay tax on amounts withdrawn from the plan if a rollover is available.

Since tax rollovers are limited, you'll want to take full advantage of the ones that are available:

- ♦ **Transfer assets to a spouse** – If you leave assets directly to your spouse, or to a trust for the benefit of your spouse under the terms of your will, you will be deemed to dispose of these assets at their tax cost. In addition, funds held in RRSPs, RRIFs and Registered Pension Plans (RPPs) can be transferred to a plan for your spouse on a rollover basis.
- ♦ **Transfer farm property to a child or grandchild** – If you own farm property, tax can be deferred if the property is left to a child, grandchild or great-grandchild. There are many conditions that must be met to qualify for this rollover, such as the land must be in Canada and used in farming by you (the deceased), your spouse, or your children, grandchildren or great-grandchildren immediately before your death. However, if the conditions are satisfied, you will be deemed to dispose of the property at your tax cost on your death. Your beneficiary will have the same tax cost. This rollover allows tax on this property to be deferred one or more generations.
- ♦ **Transfer your RRSP to an infirm child** – If you have a child who is dependent on you due to a mental or physical infirmity, it may be possible for you to transfer some or all of your RRSP to the child on death. Consult your BDO advisor to determine whether you qualify.

Use an estate freeze to defer tax on future gains

Where a tax rollover isn't available, you can still use a common tax planning technique known as an "estate freeze" to ensure that future gains will be taxed in the hands of your heirs.

What is an estate freeze?

An estate freeze is a process where you take steps to ensure that the future growth of your estate accumulates in the hands of your intended beneficiaries. By freezing the value of your estate, you will effectively lock-in the tax that will arise on your death (subject to changes in tax rates in the future). Consequently, an effective estate freeze will allow you to pre-determine the taxes that will arise on your death so that you can ensure that cash will

be available to pay that tax (for example, by taking out sufficient life insurance).

There are many ways to accomplish an estate freeze. One common method is to transfer the assets you want to freeze to a corporation. By taking back fixed value shares (usually preferred shares), this transfer can be accomplished on a tax-deferred basis using special rollover provisions in our income tax rules. Your beneficiaries can then subscribe for the growth shares (usually common shares) of the company. At the time of the estate freeze, the value of these common shares would be nominal, as the value of the property you are freezing has been incorporated into the value of your preferred shares. However, as the assets in the company grow in value, the value of the common shares will also grow. You can continue to control the assets in the company by ensuring that you can outvote the common shareholders. Control can also be achieved through the use of a family trust.

If you already have an incorporated business where you hold the common shares, there are two main estate freeze alternatives. First, you can use a holding company freeze by simply transferring the shares of your corporation to another corporation, as we just discussed, in exchange for preferred shares. Alternatively, you can reorganize the share capital of your existing corporation to accomplish the freeze. Under this scenario, you would transfer your common shares back to your corporation in exchange for preferred shares. Your beneficiaries could then subscribe for new common shares.

Although there would be a number of factors to discuss with your BDO advisor, a holding company freeze can provide additional benefits that are well suited for the current economic environment. If your business corporation has funds that are not currently needed in the business, these funds can be paid by the business corporation to a holding company on a tax-free basis. This will help ensure that the funds will be isolated from future business risks that may arise in the business corporation without a tax cost. It may even be possible to take this planning one step further by borrowing to pay a larger dividend to the holding company and loaning the funds back to the business corporation on a secured basis to pay off this loan.

Before undertaking an estate freeze, you should carefully consider whether you will have enough assets to live on without the future growth of the frozen assets. It is possible to structure the freeze so that you can reclaim future growth, but this will usually undo the value provided by the freeze.

What if I'm not sure whether a full estate freeze makes sense?

If you are unsure whether now is the right time to freeze the value of your assets, keep in mind that there are other options, such as:

- ***Do a partial estate freeze*** – Under this option, once the value of the assets has been frozen (as an interest in preferred shares), you can subscribe for

some of the new common shares along with other family members. This will ensure that you participate in future growth while still deferring tax on some of the growth. In the future, once you are satisfied that you have accumulated enough value based on the preferred shares and your new common shares, you can freeze again to exchange your common shares for additional preferred shares.

- ***Freeze the value of common shares later if necessary*** – If you do discover that you need additional wealth later, it may be possible to freeze the common shares held by your family and then all of you can subscribe for new common shares, so that you can participate in growth accruing after this freeze.
- ***Thaw the freeze*** – Provided that a family trust is used to hold the common shares for your family, it may be possible to undo a freeze in the future by naming you or your spouse as a beneficiary of the trust.

How does an estate freeze reduce or eliminate tax?

As we have just discussed, an estate freeze allows you to lock-in the value of your investments, which in turn means that the capital gain on death that you will face will also be locked-in at current levels. This means that future growth will accrue for the benefit of other, younger family members. A tax deferral will be achieved if they continue to hold the common shares after your death.

When deciding on whether an estate freeze makes sense, there is one key issue to consider: will your family continue to hold the property in question, or will they sell it when you pass away? If your family will sell the property, then this will reduce or eliminate the tax deferral benefit.

However, even if the property in question will be sold, it is important to remember that an estate freeze will allow you to multiply a key tax reduction tool – the capital gains exemption. If the shares of your corporation are shares of a qualified small business corporation or are qualified farm or fishing property, you can shelter up to \$750,000 of gains (\$375,000 of taxable capital gains) from tax by claiming the exemption. Each member of your family can be eligible provided that they realize appreciation as a shareholder.

Does an estate freeze provide other benefits?

In addition to the tax deferral benefit and the ability to multiply the capital gains exemption, an estate freeze can provide other benefits, such as:

- ***Income splitting*** – If you already have a corporation and you want to split income with other family members, a common first step is to freeze the value of the corporation so that family members can buy common shares at an affordable price using their own money.

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- **Probate tax planning** – Where probate tax is an issue, freezing the value of a corporation will also lock in the probate tax on death. In Ontario, transferring assets to a corporation can also ensure that probate tax will not be payable at all with proper will planning.

Consider a family trust

One common concern for most business or portfolio owners is losing control over the property that they want to freeze. Another issue is that the current owner may like the concept of transferring future asset appreciation to the next generation in general, but they are not ready to decide now on who specifically should get this future growth. A discretionary family trust is a tool you can use to deal with both issues.

The main advantage of a trust is that it allows you to separate the control and management of an asset from its ownership. This fact makes trusts a powerful tool. How is this accomplished? It all stems from the legal arrangement involved in setting up a trust and the tax rules that apply to them. A trust is a legal relationship between three different parties. First, there's the settlor of the trust. This is the person who sets up the trust and contributes assets to it. The settlor also sets out instructions on how the assets are to be used or managed and who will benefit from them. These instructions are set out in the trust agreement. Next, the person (or group of persons) the individual appoints to control and manage the assets in the trust is known as the trustee(s). Finally, there's the person, or group of persons, who will benefit from the assets owned by the trust. They are known as the beneficiaries. Most family trusts are discretionary, which means that the trustee can decide at a later date who will benefit from the trust capital and income.

When you combine the legal and tax aspects, a family trust essentially allows you to set aside property for a group of beneficiaries under the care of a trustee and you can decide later who gets the property. In the context of an estate freeze, it will be this family trust that buys the common shares after you have received preferred shares in exchange for your property. Future appreciation will accrue to the beneficiaries as a group, and not to you. Once you are ready, you can transfer the common shares from the trust to the beneficiaries without triggering a tax liability.

There is a catch to this planning – a family trust will be deemed to dispose of its property after 21 years. Therefore, you will need to keep this in mind when you set up the trust, and the key question will be whether you'll be ready within 21 years to split up the common shares and transfer them to your beneficiaries on a tax-deferred basis. For more information, see our bulletin entitled *Understanding Trusts*.

Probate tax and U.S. estate tax

In addition to income tax, other taxes can arise on death, including probate tax and U.S. estate tax. Unlike income tax, these taxes are based on the value of your estate and not accrued gains. However, with planning, it is possible to reduce the effect of both taxes on your estate.

Probate tax

With higher provincial probate taxes in B.C., Ontario and Nova Scotia, planning to reduce these taxes has become important in these provinces.

Probate tax has to be paid to a province when a court confirms the validity of a will. If you need a probated will to transfer ownership of one asset referred to in the will, unfortunately the value of other assets will be subject to probate tax. This may be with reference to assets named specifically in a will (as is the case in Ontario), or to all assets that form the estate.

Several provinces charge a tax based on the value of the assets with no upper limit. The highest rate in Canada applies in Ontario where the top rate is 1.5%. In Nova Scotia, the top rate is 1.479% while in B.C. the top rate is 1.4%. There are several techniques to reduce these taxes. If you name a direct beneficiary for your RRSP, RRIF, TFSA or insurance policy, the proceeds payable on death will go directly to that person rather than passing through your estate and therefore avoid being subject to probate. Probate can also be avoided on assets that are held jointly with rights of survivorship with other persons such as your spouse or children. Again, ownership of the property passes directly to them when you die.

More sophisticated planning techniques are also available. Examples include using dual wills for Ontario residents, one covering assets that require probate and one covering assets that do not require it.

In addition, rollovers are allowed to certain trusts. Where assets are held in these trusts at the time of death, the assets do not form part of your estate, and are therefore not subject to probate tax. It should be noted that these trusts will have a deemed disposition for income tax purposes on your death, so these trusts should not be used for an estate freeze.

When planning to reduce probate tax, you should always keep in mind that probate tax planning is only one aspect of an estate plan. You may have other goals that will mean incurring more probate tax than you would like. For example, using probate tax reduction techniques to exclude assets from your estate will usually reduce the amount of assets available for testamentary trusts. The tax planning value of the testamentary trusts can greatly exceed the probate tax saved. We discuss the importance of testamentary trusts in the "Minimizing tax after your death" section of this bulletin.

U.S. estate taxes

If you own U.S. property, you should be aware that the U.S. imposes a tax on estates. When U.S. residents and citizens die, they are subject to an estate tax based on the value of their worldwide estate. However, even if you're

not a U.S. citizen or resident, you may still be subject to U.S. estate taxes, based on the value of your U.S.-situs property.

U.S.-situs property includes real estate (e.g. Florida condominiums), personal property located in the U.S. (such as boats and furniture) and U.S. stocks and bonds (even when held through a Canadian brokerage account). The Canada-U.S. tax treaty alleviates U.S. estate tax concerns for many Canadians. Generally, Canadians with smaller worldwide estates do not have to worry about U.S. estate taxes. For more information, see our *U.S. Estate Tax Issues for Canadians* tax bulletin.

There are planning opportunities available to reduce your exposure to U.S. estate taxes on your death. Consult your BDO advisor if U.S. estate taxes are a concern for you.

Transferring your estate

Once you have taken steps to maximize the value of your estate and reduce the taxes payable on it, you need to ensure that your estate is passed on to your heirs in accordance with your wishes. Although a number of issues will need to be reviewed and dealt with, there are two major problems that can arise. First, if your instructions are not clear and legally effective, your assets may not pass to your intended heirs. The best way to ensure that these uncertainties don't arise is to have a properly drafted will. Second, even with timely planning to reduce and defer income taxes and other costs, there will be costs that your executors will have to pay after your death. Therefore, unless there is enough cash available after death, your executors may have to sell some or all of your estate assets to pay for these costs. To avoid this, you should ensure that there is enough cash available after death to pay these costs. For many individuals, the best solution for this problem is life insurance. We discuss both of these issues in the balance of this section.

Wills

There are several ways to transfer your assets to your heirs. For individuals interested in reducing probate taxes, assets can be transferred by way of a gift or a transfer to certain inter-vivos trusts. Another option is to transfer title of assets to joint ownership. However, each of these transfers can involve giving up control over an asset, either in whole or in part and can trigger an immediate disposition of the asset for income tax purposes. Due to this, most individuals transfer assets to their heirs by using a will. This allows you full control and the use of your estate during your lifetime.

A will is a legal document that contains instructions to carry out your wishes on your death. It is this document that determines who will receive your assets, how and when the amounts will be paid, and any other

instructions important for an orderly distribution of your estate. In addition, if you have minor children, your will is the best place to clearly set out your wishes as to who should be the guardian for your children.

Every adult should have a will. If you die without a valid will, you will have died "intestate." This means that the court must appoint someone to administer your assets. If you do not have any next-of-kin, the courts may turn your estate over to provincial authorities. Even where you do have next-of-kin, it is unlikely that provincial estate division rules will match your wishes.

A key decision you need to address when drafting your will is the choice of an executor. As your executor's main responsibility is to carry out your wishes, choosing the right person is important. Although many individuals feel obliged to appoint a family member as executor, you need to ask yourself an important question—will that person have the ability to carry out the duties required. In many cases, acting as an executor can be a large undertaking, and the responsibilities will arise at a difficult time. There are a number of issues that should be considered when choosing an executor and your BDO advisor can help you with this decision.

Finally, it is very important to consult your lawyer when drafting a will. They will help you ensure that your will is valid and will carry out your wishes. They will also make sure that it is consistent with the Family Law Act in your province, which is necessary to avoid any challenges to your will after your death. In some jurisdictions, family law can override provisions in your will.

Life insurance

Life insurance is an important part of many estate plans, and can be used for a number of functions, as we discuss below. In addition, you may use existing insurance for different purposes as you proceed through different stages of your life.

Protection for Your Family - Generally speaking, individuals first buy insurance as protection for members of their family. For example, you may want to ensure that you have sufficient life insurance to pay the mortgage on your home so that your family will not have to give up their home if you die.

Building an Estate - Once their children are older, many individuals still continue to hold insurance as a means of building their estate. On your death, the proceeds of the policy can benefit a specific beneficiary or can be made payable to your estate, to be distributed in accordance with the instructions in your will. In many ways, a life insurance policy can be considered to create an "instant estate" on your death.

Funding Tax Liabilities Arising on Death - Later in life, funding tax liabilities that will arise on your death may become very important, especially if you own a business. If your executors do not have sufficient funds to pay these taxes, they may be forced to sell your business to pay the taxes arising on your death. Life insurance is

extremely valuable in these situations, as the insurance provides a source of funds to pay this tax cost, and the receipt of the insurance by your executors will generally be tax-free. If you've done an estate freeze, you will be in a good position to estimate the taxes that will be triggered and how much insurance you'll need.

Funding Buy-Sell Agreements - If you carry on business with others outside your family, you may be required to buy the interest of your business associates on their death, or your executors may be required to sell your interest when you die. Life insurance is again a useful tool, which can be used to fund these buy-sell agreements. The use of insurance will ensure that the business will have enough funds to buy out the estate of you or your partners with minimal disruption to the business.

You should regularly evaluate your insurance needs to ensure that you have the policies in place that are appropriate for you. Your BDO advisor is ready to help.

Minimizing tax after your death

Earlier in the bulletin, we discussed methods you can use to minimize taxes arising on death, but there are some additional techniques that your executor and family can use to reduce or defer tax after your death, as well.

Provide for a testamentary trust in your will

A testamentary trust is a trust that is created on the death of an individual, under the terms of the deceased's will. It's taxed much in the same way as an inter-vivos trust, with two major and beneficial exceptions.

First, where income is taxed in a trust, tax is generally payable at the top Federal and provincial personal tax rates. However, in the case of a testamentary trust, these trusts pay tax using the marginal rates available to individuals. If members of your family will be in the top personal tax bracket in the future, a testamentary trust can provide significant savings. In addition, the savings can be multiplied, as you can set up an individual testamentary trust for each of your children.

Testamentary trusts can also offer a timing advantage. Unlike other trusts and individuals, a testamentary trust can have a non-calendar taxation year. This can be beneficial where income of the trust is allocated to a beneficiary. When the income is paid or payable to a beneficiary, the income is taxable to the beneficiary in the calendar year in which the trust's taxation year ends. For example, let's assume that a testamentary trust has a January 31st year-end. If a dividend is received by the trust in February 2009, that dividend will be included in the trust's tax return for the taxation year ending January 31, 2010. If the trust allocates the dividend to a beneficiary, that income will be taxed in the individual's tax return for 2010, and tax

on that income won't be due until April 30, 2011—more than two years after the income was received.

Estate freeze for your beneficiaries

If your children have children of their own, they may also want to do an estate freeze, particularly if they will receive property from your estate. As discussed earlier, you will be deemed to dispose of most assets on death at their fair market value, and therefore, your beneficiaries will have a high tax cost when they inherit the asset. If a freeze is performed shortly after your death, your beneficiaries can ensure that gains accruing in the future will be taxed in the hands of your grandchildren.

Consider winding up your holding company

If you own shares of a company, and the assets of the company are composed primarily of marketable securities and cash, there is a potential for double-taxation that should be addressed in your estate plan.

The potential problem is related to the fact that there are two ways of realizing the value of a corporation from a tax point of view. First, if you sell the corporation (or are deemed to dispose of it on death), the accrued gain is taxed as a capital gain. However, if you decide to liquidate the company's assets and wind up the company, the net gain is generally taxed as a dividend.

A problem can arise when you hold shares in a holding company at death. You will have a capital gain on the shares, and your heirs will take over the company with a higher tax cost. However, if your children decide that they want to realize the value of the holding company in cash, it is unlikely that they will find a buyer for the company's shares, and they may proceed to wind it up. Double tax can arise, as your children will realize a dividend on wind up. Although they will get credit for the high cost of the shares as a capital loss, this loss can only be used to reduce capital gains. Consequently, even though capital losses can be carried forward indefinitely, if your children don't earn capital gains in the future, they may not benefit from this loss.

There is a solution to this problem. However, communication with your family is important. If your children intend to wind up the company, you should ensure that the holding company is wound up while the shares are still held by your executor (during the first year of the estate). Where a deceased individual's estate realizes a capital loss in the first taxation year following death, that capital loss can be carried back to offset capital gains arising on the deceased's final tax return.

Alternatively, it may be possible to reorganize the capital of the corporation so that the cost base created by the deemed disposition on death is converted into paid-up capital on shares or a loan payable to the estate. Note that this plan won't work to the extent that the deceased (or a related party) previously claimed either the capital gains exemption or protection under the 1971 V-day rules on the shares. It may also be possible to increase

the internal cost base of capital assets held by the corporation.

To ensure that this planning is done on time, it is advisable to put specific instructions in your will.

Maximizing tax deductions and credits

When tax returns are prepared for deceased taxpayers, there are a number of rules that can be used to lower taxes payable by the estate, which include:

- ♦ **Elections to include income on a separate return** - In addition to the last regular tax return for a deceased individual, there are additional elective returns that can be filed. The most common of these elective returns is a return for rights and things receivable. A right or thing is an income item that is due to a taxpayer, but is not received until after death. A common example is an unpaid dividend that was declared before a shareholder's death. In addition, even if you do not provide for an ongoing trust under your will, it may be possible to file a trust return to report income earned by your estate as a testamentary trust. Elective returns provide an advantage, as tax is calculated on each return using a separate set of marginal rates, and in the case of

elective personal returns, additional tax credits are allowed.

- ♦ **Ensure that an exemption is claimed for death benefits received** - Where a benefit arises due to the death of an employee, the first \$10,000 of the benefit is not subject to tax.

Your BDO advisor can work with your executor to ensure that the taxes owing by your estate are minimized. In addition, there may be steps you can take prior to death in order to take full advantage of the special tax rules that apply for deceased taxpayers.

Summary

Estate planning is very important, no matter what stage of life you're at. In this bulletin, we've touched on a number of issues that you need to consider. Remember that as you grow older, your needs and goals will change. Therefore, your estate plan will also have to be modified. Estate planning is not static—constantly review your plan to make sure that it continues to be relevant for you. Talk with your BDO advisor to see what action you should be taking.

This is a publication of BDO Dunwoody on developments in the area of taxation. This material is general in nature and should not be relied upon to replace the requirement for specific professional advice. The information in this document is current as of October 15, 2009.

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