

HOW *NOT* TO AVOID PROBATE

Probate. Clients despise it. Advisors try to plan around it. Lawyers can bill hundreds of dollars in legal fees setting up trusts in an attempt to one day avoid it. As **JAMIE GOLOMBEK** explains, there are pitfalls with some of the commonly used probate-avoidance strategies that could result in the client paying more probate tax than he or she is attempting to avoid

While much has been written over the years about how to avoid probate, the time has come for a frank discussion of some of the dangers of common probate-avoidance strategies and how they may end up backfiring if clients are not properly informed about the risks associated with them. Before dis-

transfer certain assets registered in your name, such as investments and real estate, “probate” is usually required. The process of obtaining court certification is known as probate. Probate serves as proof to financial institutions, financial advisors and the land registry office that your will has been certified by the court and that your executor is authorized to represent your estate.

If you delve deeper into the probate

WHAT PROPERTY IS INCLUDED WHEN CALCULATING PROBATE TAX?

The cost of probate is generally based on the fair market value of all property that you own at the time of your death. Some assets are excluded from valuation for probate purposes. These include:

- life insurance policies, segregated funds and RRSP or RRIF accounts with a named beneficiary;

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cussing some of the pitfalls of three of the most common probate-avoidance strategies, let’s begin with a brief review of the probate process itself and its true purpose.

WHAT IS PROBATE?

When you die, your will gives legal authority to deal with your estate to your executor. Although your executor is legally entitled to do so, when the time comes to redeem or

process, however, it’s not the process itself that garners so much attention and grief but rather the fees associated with the probate process. Most provinces charge a fee or tax to probate a will and, although the services provided are identical from province to province (with the exception of Quebec), the cost varies dramatically from non-existent in Quebec to a high of 1.5 per cent of the value of the estate in Ontario.

- assets registered in joint names and which, on the death of the first person, automatically pass to the survivor(s) by right of survivorship; and
- assets owned through a formal inter-vivos trust.

Each of these exceptions has formed the basis for a probate-planning strategy, which, if the client is not properly educated as to both the legal and tax risks associated with

the particular strategy, could end up costing the client much more than the probate tax he or she is attempting to avoid. Let's discuss each strategy and what to watch out for.

BENEFICIARY DESIGNATIONS

You can name a beneficiary on life insurance policies, segregated funds, RRSPs and RRIFFs. As long as there is a named beneficiary who,

RRSP while David would be the sole beneficiary under her will.

Upon Barbara's death, the \$300,000 RRSP was paid out directly to Cathy, with no withholding tax as the trustee is not required to withhold tax upon death. The tax liability, however, falls to the estate. Assuming a 40 per cent average tax rate on the fair market value income inclusion of the

other than your spouse or common-law partner may trigger immediate capital gains tax.

To avoid the problem of having capital gains triggered when an account is registered in joint names with an adult child, some advisors have suggested the use of a "side document." This document is generally in the form of either a statutory declaration or declaration of trust stating that the child(ren) added

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in the case of an individual, is still alive at the time you die, the value of the designated asset will be paid directly to the beneficiary and be excluded from the value of your estate for probate purposes.

What happens if the beneficiary you named dies before you do? Unless you've named an alternate beneficiary, the value of the designated asset will generally be included in your estate and will then be subject to probate tax.

Another option is to set up an insurance trust to receive life insurance proceeds on behalf of your beneficiaries. This type of formal trust is most often created by a declaration in your will. Because the insurance policy pays directly to the trustee named in your will, the proceeds are not considered to be part of your estate for calculating probate taxes. If you are considering using an insurance trust, it is important to discuss this with your legal advisor.

So, what can go wrong? Unfortunately, the courts are filled with cases of disappointed beneficiaries who end up fighting over the

\$300,000 RRSP on Barbara's terminal tax return, there would be a tax liability of about \$120,000. This liability will be paid out of the only asset remaining in the estate – the \$300,000 in mutual funds. David, who is the sole beneficiary under the will, will only inherit what's left of the \$300,000 in mutual funds, or about \$180,000.

Surely this was not the result that Barbara intended when she named Cathy as the sole beneficiary of her RRSP. She probably should have named both Cathy and David as co-beneficiaries of the RRSP and also included Cathy in her will so that each child would share in the tax burden of the estate and ultimately end up receiving the same after-tax amount. (*A more detailed discussion of what can go wrong with beneficiary designations may be found in "Revisiting Beneficiary Designations," Ahead of the Curve, FORUM, March 2006.*)

JOINT OWNERSHIP

The second most common method of avoiding probate tax is to hold non-registered

to the account has only a legal interest and not a beneficial interest in the account.

The Canada Revenue Agency (CRA) has commented on several occasions that if, in fact, the beneficial ownership of the account has not changed, no disposition for tax purposes will have occurred on the transfer of the account to joint ownership. As a result, the parent would not be faced with a capital gain upon the transfer of the account and the child(ren) would not be faced with a capital gain, nor would they automatically get their share of the proceeds of disposition should the parent decide to sell the property at a later date (prior to his or her death).

The problem with this strategy is that it may not be effective to avoid probate taxes on the value of the account when the parent dies. The reason is that in such a situation, a beneficial or equal joint tenancy arrangement does not exist. This type of beneficial or joint tenancy must have several attributes, one of which is known as the "unity of interest," which means that each of the co-owner's interests must be equal in

Perhaps the biggest problem with joint ownership is the income tax liability that might arise since a transfer of property to someone other than your spouse or common-law partner may trigger immediate capital gains tax.

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Consider, for example, Barbara, a widow, who had two adult, non-disabled children, Cathy and David. For the sake of simplicity, let's assume that Barbara owned only two assets: non-registered mutual funds worth \$300,000 and an RRSP, also worth \$300,000.

Upon her death, she wanted to treat both kids equally – or so she thought – so she named Cathy as the sole beneficiary of her

assets jointly. This is known as "joint tenants with right of survivorship" and is not available in Quebec. Assets held in this manner automatically pass to the surviving joint owner or owners. Since the assets do not form part of the estate, they are not subject to probate tax.

Before placing accounts in joint names, there are some potential risks that need to be taken into consideration. Perhaps the biggest problem is the income tax liability that might arise since a transfer of property to someone

nature, extent and duration. If a child signs a document that he or she has "no beneficial interest" in the account, then surely his or her interest and that of the transferor parent are not equal.

Note, however, that whether this "side document" is effective to reduce probate taxes is not the same issue as whether this tactic is effective to avoid the need to actually obtain letters of probate. If all of the parent's property is registered in joint tenancy with his or her child(ren), third parties who

have possession of, or control, title or registration of the jointly owned account will have no reason to question the manner in which the title of the account is registered. Upon receipt of proof of death, these third parties would simply reregister the account in the child(ren)'s name without requiring

personal residences are involved, the dangers are even greater because each co-owner of the property may jeopardize his or her access to the principal residence exemption as well as his or her eligibility as a "first-time home buyer" for purposes of participation in the Home Buyers' Plan.

highest marginal tax rate from its first dollar of income, any capital gains resulting from the deemed disposition of assets upon death will be taxed at the highest marginal capital gains tax rate. If you're not in the top bracket in the year of death, it would have been more beneficial if the deemed dispo-

Since the alter-ego trust is an inter-vivos trust, which is taxed at the highest marginal tax rate from its first dollar of income, any capital gains resulting from the deemed disposition of assets upon death will be taxed at the highest marginal capital gains tax rate.

probate. If, however, even one of the parent's assets is left in his or her name and probate is required to transfer that asset, the full value of all of the parent's property (including jointly registered accounts) must be included in valuing his or her estate and calculating the tax owing.

Setting aside the income tax issue, a transfer of property generally means not only a loss of control over the property but quite often the inability to make decisions relating to the property without the consent of the joint owner. Assets held in a joint account may form part of creditor proceedings if one of the joint account holders becomes insolvent or declares bankruptcy.

In addition, there is potential for real conflict upon the death of the parent, where only one child is registered as a joint owner. When the parent dies, the child becomes the sole owner of the account, which may lead to a dispute with other siblings or family members who believe that they should have a claim on the jointly held account.

Finally, if the account was transferred to an adult child, it may also become open to division upon breakdown of marriage or common-law partnership of the child and his or her spouse or common-law partner. If

Generally speaking, joint ownership, other than between spouses or partners, is not recommended as an ideal strategy to avoid probate.

REVOCABLE LIVING TRUSTS ("ALTER EGO" AND "JOINT PARTNER" TRUSTS)

One of the newer, yet more complex strategies often recommended to avoid probate tax is to transfer assets, while you're alive, to a revocable, inter-vivos trust such as an alter-ego trust (AET) or joint-partner trust (JPT). By transferring the assets to the trust before death, the assets are no longer considered to be part of your estate and thus, at death, no probate taxes are due.

Using a formal trust lets you benefit from the income (and the assets, if necessary) during your lifetime, but have the assets distributed directly to other beneficiaries after your death, avoiding the need to go through the probate process (unless there are other assets that exist outside the trust).

The biggest problem with this strategy is that upon death, the assets in the AET are deemed to be disposed of at fair market value, thus giving rise to potential capital gains tax inside the trust. Since the AET is an inter-vivos trust, which is taxed at the

situation on death occurred in the terminal tax return, subject to graduated rates, as opposed to inside the trust.

The second problem is that having assets in an AET upon death precludes them from being transferred to a testamentary trust upon death of the settlor. This negates post-mortem income-splitting strategies that may otherwise be available through the use of one or more testamentary trusts.

These two tax disadvantages, along with associated costs of setting up and maintaining the trust, generally negate most probate-savings sought from the use of such trusts. (*More general information about AETs and JPTs may be found in "Beware Your Alter-ego Trust," Tax & Estate Planning, July 2003, FORUM.*)

When discussing the various probate-planning strategies with clients, inform them of the risks associated with each strategy. By reviewing the disadvantages, you could save clients a lot of unnecessary tax and litigation costs. Not only will you save them money and hassle, you will also be seen by clients as a knowledgeable and trustworthy advisor. **F**

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