Protecting an Inheritance from Creditors

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Fact Scenario

George is a businessman whose business has not been doing well lately. He has decided to put the business into bankruptcy. Due to the nature of his business and some of his creditors, he will have some personal liability which will also require him to declare personal bankruptcy.

Fortunately for George, when the business was doing very well, he and his spouse arranged their affairs so that most of their personal assets were owned by his spouse, Sally, who is not involved in the business and has no personal liability with respect to the business.

George and Sally are both currently age 45. They have two minor children, Dave age 12, and Ann age 8. Sally's will currently leaves her entire estate absolutely to George, but if he predeceases, then it will be divided equally between their two children, on trust to age 25. Sally owns the following assets in her name alone:

Asset	Value
• House	$350,000
• Cottage	$450,000
• Strip Mall, 30,000 square feet	$1,000,000
• Investment portfolio	$500,000
• RRSPs	$500,000
• Life insurance	$1,000,000
Total estate value	$3,800,000

George's parents, Bill and Mary, both age 76, are not in good health but are still competent. George is very concerned that they may not survive the year. Bill and Mary have two children and their current wills divide their estates equally between their two children, George and his sister. The value of Bill and Mary's estate is about five million dollars and George therefore stands to inherit about $2,500,000.

The Estate Planning Problems

If George's parents die, George will inherit half of their estates. If he is bankrupt, his trustees in bankruptcy will take his inheritance for payment of George's creditors.

If Sally dies, her entire estate will pass to George. If he is bankrupt, his trustees in bankruptcy will take the inheritance for payment of George's creditors.

The Solutions

Parent's Wills: Discretionary Trust for George and his Family

George should consider asking his parents to change their wills by establishing a discretionary trust for George, his children and potential grandchildren. The trust would provide that his inheritance would be held on trust for George's life. The trustees would have total discretion concerning how much income or capital is paid to any of the beneficiaries. The trust would provide that George would have no legally enforceable right to any of the income or capital. The trustees would have the power to totally exclude any of the beneficiaries in any year.

If George remained in bankruptcy, the trustees might decide to pay money for the benefit of George's children for their maintenance, education, benefit and advancement. The trustees might have to pay some of the funds to George or his spouse as guardians of the children, but the trustees could take precautions to ensure that the funds were used only for the children. Hopefully, George will eventually emerge from bankruptcy with no attachment to his interest in the trust. At that time the trustees might be inclined to pay some of the income or capital for George's benefit in order that he could have a reasonably comfortable retirement. On George's death, the funds remaining in the trust would be divided amongst George's children, with a gift over to grandchildren, should a child predecease George. The parents should obtain independent legal advice for this estate plan.

George's parents should decide whether or not to include George's spouse, Sally, as a beneficiary of the trust. If Sally were a beneficiary, the trustee's could pay some of the

income or capital to Sally for her maintenance and support. They would of course want to take care that the funds are used by Sally for the benefit of her and the children, and not as a ruse for channeling money to George. If the parents have any concern about George and Sally's marriage, they might want to provide that if they ever separated or divorced, then Sally would cease to be a beneficiary of the trust.

The choice of trustee is critical. George should obviously not be a trustee. But the parents could provide for the appointment of alternate trustees in the future. If George emerged from bankruptcy, the trustee might consider appointing George as a trustee at that time. George would have to remember that if he became a trustee, he is a fiduciary and must act in the best interests of all the beneficiaries. He should not wind up the trust and take everything for himself unless the trust allows for this, and then only with proper legal advice concerning his duties as a fiduciary. The parents might want to make the trust as flexible as possible by giving the trustees the power to vary or collapse trust without the necessity of a court order that would otherwise be required under section 42 of the *Trustee Act*.

The parents should think about what would happen to the assets in the trust in the event of a family demise: if all of George, Sally and all of their children died prior to the termination of the trust. They would not want the estate to fall into George's estate and then be subject to the claims of his creditors. They should therefore provide that in this eventuality, the funds remaining in the trust would pass to George's sister, or her children or to other beneficiaries such as a charity.

There are some tax advantages to George with this type of trust. The estate value is large and George would be in a high tax bracket if he were the sole beneficiary. Most of the inheritance will be invested with the income being taxed at George's marginal tax rates. If the inheritance was held in a testamentary trust, George could make a joint election with the trustees under the *Income Tax* A*ct* to have income taxed in the trust. The income could then be split between George and the trust and thereby be taxed at lower marginal tax rates. In this circumstance, a trust in the will could save substantial tax annually. This is particularly so when George is over 69 and receives all of the income from a Registered Retirement Income Fund.

If George's children and grandchildren are included as beneficiaries of the trust, some of the income can be paid to them or used to purchase necessaries for them. Any income paid to or for a beneficiary is taxed in the hands of that beneficiary. If minor children and grandchildren are included as beneficiaries, the first $8,012 of their income is not taxed (the basic personal exemption in 2004). If George's spouse was included as a beneficiary of the trust, it would allow further income splitting with her.

Sally's Will: Qualifying Spousal Trust and Tainted Discretionary Trust

Sally should change her will by establishing a trust for George and their children. One alternative is to have a trust similar to the trust outlined above for George's parents' wills. The difficulty is that under the *Income Tax Act*, in order to obtain a rollover of capital assets, a qualifying spousal trust must provide that spouse will receive all the income and no one but the spouse may be entitled to any of the income or capital of the trust for the life of the spouse. The suggested discretionary trust is a tainted spousal trust and does not qualify for a rollover. The capital assets owned by Sally which go into this trust will be deemed to be disposed of on her death at fair market value thereby resulting in one half of the capital gain being taxed as income in Sally's terminal income tax return. Sally should therefore consider placing the taxable assets in a qualifying spousal trust and the non taxable assets in a discretionary trust for George and the children and grandchildren.

The following assets could be placed in the qualifying spousal trust:

- Cottage $450,000
- Strip Mall, 30,000 square feet $1,000,000

The following assets could be placed in the discretionary trust:

- House $350,000
- Some of the investment portfolio $500,000
- Life insurance $1,000,000

The principal residence is not taxed, and the executors can choose between the cottage and the house. The residence with the higher capital gain should be designated as the principal residence (leave this decision to the executors). Careful thought should be

given to who should be a beneficiary of the trust of the residence. It is probably better to draft it as a separate trust for the residence for the use of the children and spouse while the children are young. One can have only one principal residence, and the trust should not put the children offside for their principal residence exemption as they leave home, get married and buy a house.

The stocks in the investment portfolio would be taxed, but if the gains are not large, it might be appropriate to pay some tax in order to achieve creditor protection. The life insurance is not taxable. For details on how to establish a creditor proof insurance trust, see the included paper on segregated funds.

Segregated funds are often recommended to clients in George's situation to avoid creditors. If Sally has some of her investment portfolio in segregated funds, she should not designate George as the beneficiary because he receives the funds from the investment absolutely. Sally should name a trustee of the funds to be held in a spousal trust or the discretionary trust for the benefit of George, the children and grandchildren. See the included paper on segregated funds on how to include them in a creditor proof life insurance trust.

There are some tax advantages to George to having his inheritance held in a spousal trust. The estate value is large and George would be in a high tax bracket. Most of the inheritance will be invested with the income being taxed at George's marginal tax rates. In this circumstance, a spousal trust in the will could save substantial tax annually. This is particularly so when George is over 69 and receives all of the income from a Registered Retirement Income Fund. Under the Income Tax Act, the spouse can make a joint election with the trustees to have this income taxed in the spousal trust at the graduated rates of tax of the trust. The spouse receives the income, but it is taxed in the trust at rates lower than the spouse would pay. Depending on the type of income, the size of the estate and the applicable tax rates, the spouse can save as much as $8,000.00 per year in tax for the life of that spouse.

The tax advantages outlined above concerning the discretionary trust in George's parents' wills also apply to a discretionary trust in Sally's will. The estate value is large and George would be in a high tax bracket if he were the sole beneficiary. If George's

children and grandchildren are included as beneficiaries of the trust, some of the income can be paid to them or used to purchase necessaries for them. Any income paid to or for a beneficiary is taxed in the hands of that beneficiary. George can also elect to have his income taxed in the testamentary trust. Any income retained by the trustees in the trust would be tax in the testamentary trust at the graduated rates of tax.

The RRSP valued at $500,000 cannot be placed in a trust. It must vest absolutely in the name of the spouse in order to obtain a rollover under the *Income Tax Act*. There are, however, two proposals before the Alberta government and the federal Department of Finance that could provide a solution if passed:

- The Wills, Estates and Trusts Section of the Canadian Bar Association has submitted a proposal to Finance Canada that the *Income Tax Act* be amended to allow for a rollover of an RRSP or RRIF to a trust for a spouse. This proposal was designed to allow an additional estate planning tool for spouses in a second marriage who want to provide access to an RRSP for the life of the spouse, but on death, to allow the remainder to be divided amongst the children of the first marriage. If accepted, this would give additional creditor protection from the spouse's creditors.

- The Alberta Law Reform Institute recommended in Report No. 91, May 2004, that all RRSPs, RRIFs and DPSPs be exempt from the claims of creditors during life. The Wills, Estates and Trusts Section of the Canadian Bar Association is in the process of submitting a proposal to the Alberta Minister of Justice that would protect all RRSPs and RRIFs from creditors during life and allow them to pass to a spouse on death free from the claims of creditors. In our fact scenario, Sally could leave her RRSP to George who would roll it into his RRSP, which would be protected from creditors. George in turn would be allowed to designate his children as beneficiaries of his RRSP, free from creditors.

In the meantime, the only solution to protect Sally's RRSP from George's creditors is:

- Allocate all or part of the RRSP to her minor children. There is a limited rollover to minor children who are financially dependent on the parent. The Trustees can

make a joint election with the children to have the RRSPs allocated to them as part their share of Sally's estate. The trustees can then purchase a term certain annuity to age 18 in order to spread the tax over a number of years. The trustees own the annuity as part of the trust for the children. This would not be part of the discretionary trust because George is a beneficiary of this trust. The RRSP must vest in the names of each of the children in order to achieve this rollover. Given the age of their children, the trustees could substantially reduce the tax on Sally's RRSP with this solution.

- If creditor protection is the primary goal, pay the tax on Sally's RRSP and have the net proceeds form part of the discretionary trust.

- Use a combination of both.

Trusts for Children

Another alternative is to establish separate trusts for the children. In other words, Sally could leave something on trust for each of the children, and a different for George and the children and a separate spousal trust for George alone.

Conclusion

All of these suggested solutions require a careful asset by asset review of the parents' and spouse's estate assets. A great deal of flexibility needs to be built into the trusts to allow the trustees the ability to adjust to changing circumstances. These are not simple trusts. George, the beneficiary, also has to understand that these types of trusts are not a mere ruse to avoid his creditors. If he emerges from bankruptcy, his inheritance could be held on trust for him and/or his children for his life, and he must understand that the trustees must carry out their duties properly. The trustees cannot simply roll over and turn everything over to George. He may be living with the trust for the rest of his life; but, if well planned, he could have a fairly comfortable life.