LIFETIME ESTATE PLANNING—A BRIEF REVIEW*

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Introduction

In a book entitled "Estate Planning" by R. J. Trevelyan of the Canada Life Assurance Company Estate Planning Division, the author points out that on the death of a man a number of financial problems arise. He then draws this very "objective" conclusion:

> "It soon became apparent that life insurance, in addition to serving its primary function, could also be used to protect and conserve the other assets of the estate. Thus it was that 'estate planning' began."

With deference to the claim made by the life insurance industry, the writer suggests it is somewhat misleading. The fact is "estate planning" has gone on for centuries.

Estate planning is a fascinating subject. It is today and has been for centuries the function of lawyers. The estate tail and the long legal struggle waged over freedom of alienation of property were direct products of estate planning. Today, accountants, trust officers and life underwriters are all involved in estate planning. They can and do provide useful functions, but they must be watched. Estate planning is fascinating because it touches so many branches of law and for this reason it is far too complicated to allow an accountant, trust officer or life underwriter a free hand, though each of these persons may be quite well versed in some aspects of trust, corporate, tax and insurance law. Estate planning is not tax planning though planning for taxes is involved; estate planning is not the sale of life insurance though life insurance may be sold as part of a plan.

In the view of the writer estate planning is simply the construction of an arrangement to facilitate the preservation of a man's wealth and the orderly devolution of that wealth on his demise.

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In this paper it is proposed to discuss briefly a number of points which may be considered in lifetime estate planning. They are by no means exhaustive nor will there be undertaken any fine legal analysis of problems. The intention is purely and simply to raise some points which may be of interest from day to day. Most of what will be said will be tax orientated.

2. Constructing A Plan: The First Step

A child's first step is the most important because it is from there that he builds and progresses into a sturdy walk. The same is true of estate planning. The first step is to GATHER YOUR INFORMATION. You must go into the most intimate corners of your client's affairs. For example, you should check to see how he and his wife get along. A previous marriage and divorce is a caution sign. All documents and the facts upon which they were obtained should be reviewed. (There is one case now going on in the Quebec Courts in which the validity of a New Brunswick divorce is being contested on the grounds that the petitioner was not domiciled in New Brunswick.) Are all the children legitimate; are any children handicapped so that special provision might be made for them. What is the nature and extent of a client's assets? What is his income? Has he made any lifetime gifts? If so have these been documented. Are there any persons other than immediate family he wishes to benefit. What are his liabilities? Has he made pledges that he wants honored. If the pledge is not binding on the estate it is doubtful that an executor could honor it in the absence of a specific authorization in the will. This is only the beginning of your job but it is vital to complete it before venturing on any estate plans. Let us now consider some problems which arise and some methods of dealing with them.

3. Estate Tax and Liquidity

Possibly the first problem which will emerge is the estate tax, probate fees and other expenses which will arise immediately on death. This is a problem of liquidity and if there are not sufficient liquid assets in the estate to meet these expenses, you must build such assets.

One method to obtain liquidity is life insurance. Under the Estate Tax Act, insurance is now taxed to the person who owns it and ownership includes such things as the right to assign the policy, to borrow on it, to change or designate the beneficiary or cancel the policy.[1] In view of these points it is wise for the client

1 See the *Estate Tax Act*, section 3(1)(m) and 3(5)(a).

not to buy the insurance himself but to allow his wife to buy it on his life. The policy proceeds can be made payable to the client's estate and the premiums can be paid by the client.

In providing for liquidity through life insurance it is vital that the wife should appoint to the husband and his estate irrevocably. If a revocable appointment is made the entire plan might be frustrated as a revocable appointment may be changed at any time. It is noted that the manner for making revocable or irrevocable appointments is set out in the new life insurance provisions. The most significant change wrought by the new life insurance provisions which came into effect on July 1, 1962 is the abolition of the preferred beneficiary statutory trust. This change brought with it changes in the law relating to insurance designations and creditors' rights to insurance money. These should all be reviewed with care for estate planning purposes.

Basically there are two ways for a wife to acquire insurance on her husband's life. She may apply for a policy on his life, that is, the initiation of new insurance and he may transfer his ownership in existing policies to her.

If the wife uses her own money to pay the premiums there is no tax problem in the first method. A latent danger lurks in the second method if the transfer is by way of gift. It is common knowledge that gifts *inter vivos* made within three years of death are brought back into the estate for estate tax purposes.[2] Couple this rule with the fair market value concept of the Estate Tax Act as set out in section 58(1)(5) and you will quickly perceive the danger. Thus, if a husband gives a $50,000.00 face value life policy to his wife which has, say, a $4,000.00 cash surrender value at the date of gift and the husband dies within three years of this gift the full $50,000.00 is brought back into the estate.[3]

Where the wife applies for the insurance but the husband pays the premiums it may be that the Department will attempt to tax under section 3(1)(j) of the Estate Tax Act. This section brings into tax "an annuity or other interest purchased or provided by the deceased to the extent of the beneficial interest arising on the death". It has been held that the words "other interest" are broad enough to include insurance.[4] However, the House of Lords has stated with respect to the same provision in the English Finance Act, 1894, that the policy must be separated from the

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2 *Estate Tax Act*, s. 3(1)(c).

3 See *Papp Estate v. M.N.R.*, 64 DTC 5074; aff'd. 64 DTC 5289.

4 *D'Avigdor-Goldsmid v. I.R.C.*, [1953] 1 ALL E.R. 403.

proceeds of the policy. The suggestion is that the interest purchased or provided is the *policy* and on death there is simply a realization of the rights under the policy; nothing new *arises* on death so that section 3(1)(j) may not apply.[5]

In order for this reasoning to apply of course the beneficiary under the policy must have an absolute right to the proceeds. If his right is merely contingent and then made certain on death there is a new beneficial interest arising.

Statements have been made by the estate tax authorities that it is the Department's intention to tax all life insurance under section 3(1)(m) and that if it does not fall within that section it will not be taxed. This statement is by no means binding and in view of the *Papp Estate* case, it is submitted that it would be advisable to approach section 3(1)(j) with caution. In the opinion of the writer, to make certain section 3(1)(j) is avoided the wife should use her *own* funds to pay the policy premiums. The husband may give her these funds but even in that event it is safer to have the wife borrow from the bank, pay the premiums and then let the husband make a gift which she uses to pay the bank. This may seem very circuitous and unnecessary, but in this field it pays dividends to proceed with caution.

Where the wife pays for a policy transferred to her by her husband but the consideration is inadequate a gift of the difference between the price paid and the cash surrender value has been made. This gift, if the transferor dies within three years, is then brought back into the estate, but only at the value at the date of transfer.[6]

Thus in transferring insurance from husband to wife it is suggested that:

1. it not be done by way of gift;
2. the wife pay full consideration for the policy; or
3. the wife pay partial consideration for the policy provided the partial consideration is not so small as to take the transaction out of the category of a sale and make it, in effect, a gift.

A gift tax question arises when a wife purchases a policy on her husband's life and appoints, say, her son as beneficiary. This is known as a third party policy. When the wife or husband pays the premiums is a gift made to the son? It is thought not. The

5 See *Westminster Bank Ltd. v. I.R.C.*, [1958] A.C. 210.

6 See *Estate Tax Act*, s. 3(1)(g).

basic reason for this opinion is that nothing has been *assigned transferred or disposed of* to the son by way of gift as required by the gift tax provisions.[7] If the son is merely a revocable appointee, it is believed that the question is without doubt. As such he has nothing. All his rights as beneficiary are subject to divestment. If he is appointed irrevocably the position is less clear. In such cases the appointee is put in a valuable position. But even in this case no *property* has been given to him.

At best, from the government's point of view, the irrevocable appointment of a beneficiary is comparable to the creation of an expectancy or *spes successionis,* neither of which can be classified as *property*. Section 139(1)(ag) of the Income Tax Act defines property as " . . . property of any kind whatsoever . . . and includes a right of any kind whatsoever and a chose in action". One doubts that this definition adds much to the common law. But even if the government could classify the rights created by the irrevocable appointment of a beneficiary as property within the meaning found in the Income Tax Act, then it is believed that the problems of valuation would render it virtually impossible to levy gift tax. On what basis would you value the beneficiaries' rights?

Other methods of creating liquidity are investments in liquid assets and cash savings. Buy-sell agreements, in addition to other functions they perform, are also valuable in providing liquid funds to an estate. They have an automatic conversion feature and save the executors the problems of finding a buyer. Capitalization of surplus and the issue of redeemable preferred shares is also very valuable in this regard. The redemption may be funded by insurance if the business is the type which has a chronic cash shortage or which may not be able to borrow.

4. Estate Splitting

(a) *General Note*

Estate tax advantages can be gained through effective lifetime estate splitting, but caution should be exercised in this area.

It is true that gifts made past the three year period and within the gift tax exemption clearly reduce estate tax, but before any man is advised to give away his property he should be told clearly and unmistakedly that a gift is an absolute transfer of property. He cannot get the property back.

For some wives a large "gift" may be her passport to independence and flight for which she has longed for many years.

7 See the *Income Tax Act,* s. 111(2).

Examples of frustrated estate planning are not hard to find. For instance in *Steinberg v. Steinberg*,[8] a husband had transferred shares of stock worth $15,000.00 to his wife. He was later advised, to avoid gift tax, to take back promissory notes from her and forgive the indebtedness over a period of four years. A year later they parted and the husband sued on the notes. The Court found the notes were of no value and that the wife was not liable on them. It cost Mr. Steinberg $15,000.00 to save $1,600.00 in gift tax. The price was a little high! Obviously not all transactions of this nature backfire so violently. The point is that the client should be advised of the possible repercussions in making gifts.

(b) *The Gift Tax Exemptions and Rates*

Every taxpayer has a basic exemption of $4,000.00 or one-half the difference between his previous year's taxable income and the tax paid thereon, whichever is greater. In addition, the taxpayer may make as many $1,000 gifts to separate individuals as he wishes, and there is the further exemption of $10,000 as a once-in-a-lifetime gift of an interest in real property. And, of course, you can give to your heart's content to charity or the Government.

A gift of property to a trustee for a number of beneficiaries can be segregated into separate $1,000 amounts.[9] In using the $1,000 exemption care must be taken to evaluate the property being given since, if the gift exceeds $1,000.00, the entire exemption is lost.[10]

The once-in-a-lifetime exemption of an interest in real property must also be employed with caution. The statute allows an exemption for a gift of "an interest in real property". Thus the sale of property to your wife in return for a promissory note or notes which are later forgiven will not qualify. The gift in this case would be of the indebtedness and not of an "interest in real property."[11] It is this sort of case which illustrates the need for lawyers to accept the recommendations and advice of non-lawyers in these matters with some care and scrutiny.

If the client is intent upon making gifts and if his estate is very large it may be advisable to make gifts beyond the exemption and pay gift tax. Gift tax rates are roughly only one-half of estate tax rates. Thus a very large gift, say in the order of $500,000 or $600,000, will yield high tax savings if the taxpayer lives for three

8 (1964), 45 D.L.R. (2d) 162.

9 See *Baynes v. M.N.R.*, (1954), 54 DTC 361.

10 *Gouge v. M.N.R.*, 50 DTC 278.

11 See *Manning v. M.N.R.*, 63 DTC 286.

years. There is one situation known of where the taxpayer has now lived the three years, and will have saved estate tax of about $800,000 even though he paid nearly $400,000 in gift tax.

There is an advantage in paying the gift tax even if the taxpayer does not live the three years. Under the Estate Tax Act, only the amount of the gift is brought back into the estate and thus the taxpayer's estate is reduced by the amount of gift tax he paid on the gift. For example, A has an estate of $700,000. He makes a gift of $500,000 to B and pays $200,000 in tax. On A's death within three years, only the $500,000 is brought back into his estate for tax, yet the total $200,000 tax will be allowed as a credit to the estate against the estate tax payable.

One last point to note is that gift tax rates are cumulative. Thus the rate of gift tax on a gift of $40,000 but not exceeding $50,000 is 15%. However, if the gift is between $50,000 and $75,000 the rate is 16%. The increase of 1% applies to the first $50,000 as well as the last $25,000. Thus the tax on a $50,000 gift is $7,500. The tax on $51,000 is $8,160. Even though the extra gift is only $1,000 the tax has increased by $660 or exactly 66%. The moral here is that if your gifts are going to be close to the start of a bracket it is better to reduce it a little to stay within the previous bracket.

(c) *Testator's Family Maintenance Act: Is there a hole in the Gift and Estate Tax Act?*

The Testator's Family Maintenance Act[12] is more than passing interest in the area of estate splitting. This Statute gives the wife and children a right to apply to a Judge for more adequate provision than is made for them under the husband's will or, if he died intestate, under the intestacy laws. The intention of a lifetime gift program may be to provide for the wife and allow the testator to leave the remainder of his property outright to say, his children, or collateral relatives or charity or other similar objects. If the wife and children are completely cut out of the will a danger of thwarting the plan will be created.

Under the Statute, a Judge considers all the circumstances, and written reasons from the testator explaining the lay-out of the will are of particular value. Thus a testator should, at the time of making his will, write a short memorandum explaining that lifetime gifts have been made to the wife and children or whatever other circumstances exist; that it has all been done pursuant to a plan; and, that the amount given is in his opinion sufficient to maintain his wife and children in the manner to which they are accustomed.

12 1959 Statutes, c. 14.

At estate tax time many people in common law jurisdiction have looked with envy and some dismay at community property taxpayers in Quebec. Our eyes are often bigger than our bellies and generally we have more than enough before us. With the enactment of the Testator's Family Maintenance Act there may be no further cause for envy in New Brunswick. It may be possible to split an estate in New Brunswick without fear of gift or estate tax.

Consider, if you will, the basis of the Testator's Family Maintenance Act. The basic rule of the English common-law is absolute freedom of testamentary disposition. Another rule is that a husband is legally bound to maintain his wife, and now by statute his children. This right to maintenance is in effect extended beyond the life of the husband. The declared rationale of the Testator's Family Maintenance Act is to limit plenary power of testamentary disposition and to ensure adequate maintenance and support for those whom the testator is morally and legally bound to support.[13] If the husband does not make adequate provision for his dependants the Court will do it for him. Under these Acts a woman's *right* to receive is established. The *amount* she receives is not established by right but by discretion.[14]

If you accept the premises just stated, then it is submitted that a wife can release her rights under the Act for a lump sum or other adequate consideration from the husband without gift tax and if he died within three years no estate tax would be exigible. It has been held that the surrender of dower rights in return for a lump sum from the husband is not adequate consideration and the transaction is taxable as a gift.[15] There has been a decision (dealt with, infra), taxing as a gift a payment made under an antenuptial agreement made by parties in Quebec wherein the wife surrendered her property rights in her husband's estate.

In the view of the writer, these cases would not be an answer to an agreement wherein a wife released her rights to present maintenance as well as all rights under the Testator's Family Maintenance Act in return for a cash payment. A surrender of such rights would be adequate consideration. The transaction could hardly be characterized as a gift. The husband is left free to dispose of the remainder of his property as he sees fit and the wife has received handsome support.

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13 See *Parish v. Parish et al.*, [1924] N.Z.L.R. 307.

14 See *Walker v. McDermott*, [1931] S.C.R. 94 for the manner of interpreting these statutes.

15 See *Pachal v. M.N.R.*, 62 DTC 289; *Leger v. M.N.R.*, 63 DTC 372.

You of course will say such a contract is void and that a wife cannot barter away her rights to present maintenance or future maintenance under the Act. It is suggested that such contracts are only voidable and if a wife has been adequately provided for under the agreement the court will not interfere with it.[16] In any event it would not be the entire contract which is void but merely the clause which attempts to oust the court's jurisdiction. You cannot, in other words, prevent the courts from reviewing the contract. Wifely support and maintenance is a matter of public concern, but if the pre-estimate of the wife's needs has been judicious the Court will not make an order.[17]

Assuming, without deciding, a contract of this nature is void, it seems possible to construct a contract within the terms of the Act which would be valid. Pursuant to section 16 of the Act, a court will not make an order affecting property bequeathed by the testator pursuant to a contract to bequeath such property except to the extent that the value of the property, in the opinion of the Judge, exceeds the consideration received by the testator therefor. Thus if a husband and wife agreed in consideration of the wife releasing dower, present maintenance and all rights under the Testator's Family Maintenance Act, that he would transfer one-half of his property to her immediately and bequeath the other half to say, his children, the contract could be upheld by virtue of section 16.

Lastly, if these arguments fail, it should be possible to have such a contract ratified by private bill and thus alleviate any problems insofar as voidability is concerned.

Under section 3(1)(a) of the Estate Tax Act the estate is taxed on all property over which the decedent was, immediately prior to his death, *competent to dispose*. The words "competent to dispose" mean uncontrolled and complete freedom of alienation of property. A statutory fetter on testamentary powers of disposition is created by the Testator's Family Maintenance Act. Could it not be argued that by virtue of this Act the decedent is not competent to dispose of all his property and therefore not all of his property can be subjected to estate tax? If this argument was successful, it would create something comparable to a community property law in the common law provinces.

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16 See *Smith v. National Trust Co. Ltd.* (1958), 15 D.L.R. (2d) 520.

17 See *Hyman v. Hyman,* [1929] A.C. 601 per Lord Atkin, page 629; and Laskin, *The Protection of Interests by Statute and the Problem of "Contracting Out"* (1938), 16 Can. Bar Rev. 669, at 690-691.

Another argument supporting the non-taxability of the inter vivos transfer of property is based on the Estate Tax Act itself. Section 3(1)(q) of the Estate Tax Act says that dower or curtesy shall not be deducted in computing the value of property passing on death. The fact that rights under the Testator's Family Maintenance Act are not mentioned suggests these rights are to be taken into consideration for estate tax purposes. Moreover, the estate tax laws make it clear that marriage, dower and curtesy are not adequate consideration to support a transfer of property *as a sale.* Again, rights to support and maintenance under the Testator's Family Maintenance Act are not mentioned. Neither of these are stated in the gift tax laws although, as has already been noted, the courts have held dower to be insufficient consideration to support a sale. No Canadian court has yet dealt with the question of whether a release of rights to maintenance and support would be adequate consideration for a transfer so as to bring it within the realm of *sale* rather than *gift.*

In *Merill v. Fahs,*[18] it was held that a release of dower and other marital rights in return for a transfer in trust of $300,000 constituted a gift. The court said the release was not adequate and full consideration in money or money's worth as required by the statute. It is pointed out that the Internal Revenue Code, 1954, defines a gift as, *inter alia,* a transfer for less than adequate and full consideration in money or money's worth. We have no similar provision in our gift tax law. Our courts rely on the general principle that if a sale is made for almost no consideration a gift is really intended and the transaction, insofar as the consideration is inadequate, is treated as a gift.

But for a decision of the Supreme Court of Canada, the Tax Appeal Board has said it would not find against the taxpayer in the type of transaction considered here. In *Houghton v. M.N.R.,*[19] the taxpayer under an antenuptial marriage contract in Quebec agreed to transfer, in 1936, $10,000 or property of equal value to his wife-to-be who in return agreed to release all her rights in his property. In 1951, pursuant to his agreement of 1936, the husband transferred property worth $23,000 to his wife. The tax department assessed gift tax on the entire amount. It was held that the release of rights by the wife under the contract was not for "full consideration in money or money's worth". The Board cited and relied on *The Royal Trust Company et al. v. M.N.R.*[20]

18 324 U.S. 308; 89 L. Ed. 963.

19 56 DTC 339.

20 [1949] S.C.R. 727; 49 DTC 685.

In the latter case, an attempt was made to take a deduction for succession duty purposes of the amount owing under a marriage contract. The Succession Duty Act, like the Estate Tax Act, required that debts be *bona fide* and for full consideration in money or money's worth before they are deductible.[21] The Supreme Court held that under the civil law and by reference to articles of the Civil Code, the husband's covenant to pay is not onerous but gratuitous in contracts of this nature. The marital rights surrendered by the wife simply did not fall into the class of "full consideration in money or money's worth". Note that the *Houghton* case was a gift tax matter and the Board said at page 342:

> "I may add that if it were not for the judgment of the Supreme Court of Canada I would have accepted the appellant's contention."

It is felt that the appellant's contention could have been accepted in this case notwithstanding the Supreme Court judgment. After all, the question for determination in the *Houghton* case was whether a *gift* had been made, not whether the husband had received full and valuable consideration in money or money's worth. These two questions are not synonomous. It is this point which the Tax Appeal Board failed to appreciate.

It would be folly to suggest that a transfer of the nature under consideration here would definitely not attract gift tax. The arguments presented, however, do support such a conclusion. The tax rewards for anyone bold enough to rely on them would be great. The risk is not too high as estate tax will have to be paid if the husband has the property in his estate at his death.

(d) *Use of Trusts and Transfers of Property as Affected by Income Tax*

The trust is no new instrument to the law and lawyers. In estate planning, living trusts are being used with increasing frequency. Following is a summary of the reasons for using trusts in an estate plan:

1. It enables an otherwise occupied client to obtain specialized property management and investment services.
2. It permits accumulations of wealth in a separate pocket not connected with the contingencies and hazards of business.
3. It prevents interruptions and delays at the time of death and facilitates the orderly transmission of property and estate administration.

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21 See the *Estate Tax Act*, s. 5(1)(a).

4. It may be a convenient vehicle to provide for the client's wife and parents and other persons in whom he is interested without making direct demands on his business income or assets.
5. A living trust enables a man to familiarize himself with a trust and its operation and allows the client himself to judge the instrument.
6. *Tax saving*. A trust can be most useful for the purpose of income splitting.[22]

Transfers of property may be made directly to the transferee or may be made directly to a trustee for the use and benefit of some person.

In making transfers of property one should be aware of sections 21(1) and 22 of the Income Tax Act. These provisions say that income from property transferred by one spouse to the other, or to a child (not necessarily of the transferor) under 19, remains taxable to the transferor. Sections 21(1) and 22(1) require that the property be "transferred to" the spouse or child. Thus it seems that a gift or transfer of property to a corporation controlled by the spouse or child would not fall within these provisions. Nothing has been "transferred to" the individuals, although there has been an accrual in value of their shares. Sections 21(1) and 22(1) refer to transfers, either "directly or indirectly". Similar words in English tax legislation have been interpreted narrowly.

In *Potts' Executors v. I.R.C.*[23] the House of Lords held, in connection with a provision of the English Income Tax Act, that a payment by a trustee to the creditor of A at the direction of A was not a payment to A either directly or indirectly. The English provision being interpreted in this case resembles the wording of section 21(1) so that the decision could easily be applied in Canada.

Lord Simonds made an interesting comment on the words "directly" and "indirectly" when he stated at p. 80:

> "I do not think it matters whether the words 'directly or indirectly' qualify the payment or the receipt. I will assume they qualify both or either."

and he went on to say at p. 81:

> "So far, my Lords, I have not specifically dealt with the word 'indirectly.' It is sufficient to say that it cannot so enlarge the

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22 For a more complete summary of the uses of trusts see Upper Canada Law Society Lectures 1957, Estate Planning, pp. 32-34.

23 [1951] 1 ALL E.R. 76.

> meaning of the words 'paid to the settlor' . . . for his own use and benefit. I do not feel called upon to determine positively what transactions it might be apt to cover. It may be that it is not apt to cover any that are not already covered by the normal meaning of the words 'paid to the settlor'."

Another point in connection with these sections is that it is only the *income* from the property transferred which is taxed. Thus, if the property is used in a business and there is income from the business the section does not apply. For example, if A gives to his wife shares of stock which she trades and makes a profit, this profit, if not classified as capital gain, will be taxable to the wife and not the husband.[24]

Section 22(2) of the Income Tax Act allows a transfer of property in trust and provides that the income from the property will not be taxable to the transferor provided (1) no reversion has been retained, (2) the settlor has not retained the right to change beneficiaries, and (3) the settlor has not prohibited disposition of the property except with his consent or direction.

This provision, together with sections 21(1) and 22(1), is designed to prevent advantageous income splitting. Obviously, in a progressive rate system, $20,000 will bear less tax if split in two and taxed twice at the $10,000 rate. To avoid the application of sections 22(1) or 22(2), it has been suggested that if the minor's right to income is made conditional on his attaining 19, then the trust will bear the tax. Notice that the trust must clearly state that the minor has no right to either income or capital *unless and until he reaches 19*. The trustee should be prohibited from advancing any income to any beneficiary under 19.[25]

There are two points of interest to note about these sections from an estate splitting point of view. Even though the Income Tax Act treats the income from the property as that of the transferor, in law the income belongs to the transferee. Thus there is a built-in extra gift tax exemption. The income from the property transferred goes into the transferee's estate without gift or estate tax. You see, the government is being generous even when it is getting its pound of flesh. Moreover, because the transferor pays the tax there is a further reduction in his estate. No estate tax will be paid on this amount. There is a point where the estate and gift tax saved is more than the income tax paid. At this point I think it fair to say the government has been "too clever by half".

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24 See *M.N.R. v. Robins,* 63 DTC 1012.

25 See Scott-Hartson, J.C., "The Lawyer In Estate Planning" (1962), 10 Can. Tax Journal 116, at 119.

In those situations where the income from the property is in the form of dividends, the taxpayer is entitled to the 20% dividend tax credit.[26] One begins to wonder if there is not some slight conflict between present income, gift and estate tax laws.

(e) *Personal Corporations*

For a very long time now personal corporations have been effective tools in estate planning. What is a personal corporation? It is no different than any other ordinary corporation created under provincial or Federal law. The term "personal corporation" is a creation of income tax. Pursuant to section 68, where a corporation is family controlled, more than 25% of its income is from investments, and it does not carry on an active commercial or financial business, it is a personal corporation.

The consequence of being a personal corporation is simply that the income of the corporation is taxed directly to the shareholders. Personal corporations are used in estate planning to avoid multiple succession duties and probate in many jurisdictions. They have been used for estate freezing and income splitting. Less known, but equally valuable, is their use in estate splitting.

An interesting case on the interrelation of a trust, a personal corporation and section 21(1) was decided by the Exchequer Court in May of 1964. In *Pichosky v. M.N.R.*[27] a husband transferred $1,600 to the Albert Pichosky Trust to pay the income to his wife for life and on her death to his three sons at age thirty. The trust then bought shares in Albert Pichosky Limited which owned shares of Stork Company Limited. Albert Pichosky Limited was a personal corporation. In 1959 Stork paid a dividend of $60,000 to Albert Pichosky Limited. The Minister assessed the husband for tax on the $60,000 under section 21(1) alleging this was income from the shares of Albert Pichosky Limited which had been purchased with the original $1,600 put in the trust.

President Jackett allowed the taxpayer's appeal. He held that section 21(1) applies only to make "income that otherwise would be taxable in the hands of the transferee being taxable in the hands of the transferor". In this case, even though section 67 deems the income of the personal corporation to have been received by the shareholder—the trust—there was in fact no income paid to the trust. Thus, there was no income payable to the beneficiary under the trust provisions of section 63(6)(7). In this instance the $60,000 would not have been otherwise taxable in the hands of Mrs. Pichosky.

26 *Income Tax Act,* s. 38(3).

27 64 DTC 5105.

The trick in this case is that the personal corporation *paid* no dividend so that there was no income in the trust taxable to Mrs. Pichosky. It is important to note that even though the Income Tax Act deems personal corporation income to be distributed this is only for the purposes of taxing that income. The manner for declaring and paying out dividends remains a matter of corporate law under the jurisdiction where the company is incorporated.

Criticism has been levelled at the *Pichosky* case. Gwyneth McGregor, writing in the Canadian Tax Journal[28] makes out a fairly convincing case for non-reliance on the decision of the Exchequer Court. The writer, however, likes the Exchequer Court judgment, and would be quick to use the interesting possibilities suggested by it.

5. Estate Freezing

The object of estate freezing is to avoid estate tax. It is not total avoidance but rather the avoidance of any further tax after a given date. For instance, you may review a client's estate and find it to be worth $300,000. The estate tax on such an estate may be quite substantial. It is therefore prudent to prevent any future growth in value of those assets from accumulating in the *client's* hands.

One popular method of accomplishing this result was to incorporate a personal corporation to which the father would transfer his growth assets in return for redeemable voting preferred shares. His children, or others that he wanted to benefit, would take back the common. Any growth would accrue to the common shares but yet, through the use of voting preferred shares, the father continued to control the direction and management of the assets.

Since the enactment of section 138A—dealing with dividend stripping—the Department says this device, where the asset transferred to the corporation is shares of stock, will be attacked. The attack will only come in those cases where the newly incorporated company is depersonalized so that earnings of the subsidiary corporation after the date control is acquired will pass tax free. There are many ways to depersonalize a corporation. One of the most popular methods is to give the corporation an "active business". Thus there are a great many hot dog stands and cigar stores

28 Vol. XII, No. 4, pp. 239-241.

around the country being operated by large corporations. Notwithstanding this fact, very careful consideration should be given to this device before relying on it.

It is not believed that the Department can press section 138A with any degree of success in these circumstances. To be on the safe side, however, it has been suggested that the best thing to do is make the second corporation a personal corporation. Estate freezing is still accomplished but income tax benefits are materially reduced.[29] Since it is the income tax benefit with which the Department is concerned it is not apt to take up the cudgels.

It is possible to do estate freezing without the use of a second corporation. In its place a *business trust* may be established with the use of redeemable preferred trust certificates and common trust certificates. The rights attaching to each of these can be made similar to what you would use for stock certificates. The same control over the assets can be obtained by allowing the father to vote the corporate stock held by the trust. Such a trust would of course be taxable on income in the manner usually applicable to trusts. This device is purely and simply a common law corporation. In the view of the writer we have not even begun to examine the possibilities of such corporations in the tax field. In the United States, this legal tool has been in use for some time.

Other means of accomplishing an estate freeze are a simple sale of the growth asset to the individual you desire to ultimately receive the increased value of your estate. These particular methods come to mind but undoubtedly others of much more ingenuity and mental wonderment could be conjured up.

6. Buy and Sell Agreements

Perverse tax consequences may arise on the death of one party to a buy-sell arrangement. For example, A and B each own 50% of the stock in XYZ Company. Under a buy-sell agreement each agrees to sell to the survivor his shares at say $50,000. On the death of A the shares are worth $75,000. A's estate must include $75,000 in gross value but B is only obligated to pay $50,000 for the stock. However, B will, unless he is a beneficiary under A's will, have to pay the estate tax on $25,000. All of this arises by virtue of sections 3(1)(i), 14, 4(3) and 4(1) of the Estate Tax Act.

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29 See 1964 Law Society of Upper Canada Lectures on Taxation, H. H. Stikeman, p. 15.

To avoid these difficulties it is wise to ensure that a buy-sell agreement contains some flexibility in the valuation clause. Moreover, if it is desired to fix a valuation and the possible purchaser is also a beneficiary under the seller's will, a clause should be inserted in the will making the successor liable for the additional estate tax on the excess valuation for tax purposes over that fixed in the agreement. It may be that the client wants to benefit the purchaser free and clear of any taxes; this, of course, will be a matter to be ascertained. It is merely pointed out that there are problems which should be considered in reaching a conclusion.

7. Conclusion

This paper has only touched briefly and in a general way on a number of points of interest in estate planning. There remains this last comment:

Lawyers have allowed much of the tax and estate planning field to pass by default to other groups. In this the lawyers have done a grave disservice to the profession generally and the public particularly. There is nothing more mysterious about this area of law than creditors' rights or domestic relations. True, it has attained a certain liturgy which is known only to the high priests of specialization; but the mumbo-jumbo of tax law can be easily mastered, through study and application, just as any other subject. Let me conclude by quoting Mr. J. T. Gow, Q.C., in his Upper Canada Law Society Lectures on Taxation 1964:[30]

> "Estate planning should be the prerogative of the solicitor. Of all those engaged in the work he has nothing to sell but his services. He alone is competent to consider all the branches of work involved and give disinterested advice. There is no doubt that estate planning is a growing field and if the legal profession does its duty, there is probably no field of legal activity more likely to develop in the years ahead."

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30 At page 456.