Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Estate planning for blended families

Where to begin with new beginnings?

Estate planning is important so that you can retain more of your assets, protect your estate and leave a lasting legacy for your family. Being part of a blended family adds another level of complexity to your estate plan. It will affect how you should divide your assets after your death. The difficult decision often comes in finding the right balance between protecting your own children and sufficiently providing for your current spouse. Leaving the decision up to either your spouse or your children as to how to divide your assets after your death leaves the door wide open for conflict and hard feelings, regardless of how good the relationship between your spouse and your children may be.

To make planning for blended families as uncomplicated as possible, it is important to communicate expectations. Be open with everyone who has a stake in the planning and discuss everyone's needs and desires. It is better to have the difficult conversations upfront and avoid unfounded assumptions, than to deal with conflict down the road as a result of a lack of communication.

So, with these considerations in mind, what else do you need to know before you tie the knot for a second, or perhaps third, time?

This article is intended for married spouses. Some of the strategies discussed in this article may not be applicable to common-law spouses. Couples entering new common-law relationships should seek legal advice in determining their respective rights and entitlements and in revising and preparing their estate plans.

New Wills

It is very important to know that in several Canadian jurisdictions, a new marriage renders all previous Wills null and void.[1] One exception to this rule is if the existing Will was made in contemplation of the marriage. If you do not make a new Will after you marry or a Will in contemplation of marriage before you marry, and then pass away, it may be viewed as if you died without a Will (intestate) and your estate will be distributed in accordance with the intestacy laws of your province of residence. Therefore, if you have re-married or plan to re-marry, make preparing a new Will a priority, regardless of how you want to divide up your estate.

It is also important to review and update beneficiary designations on registered plans and insurance policies, as marriage does not necessarily revoke prior designations made on the plan documentation or policy, such as a designation in favour of a former spouse.

Restrictions on testamentary freedom

There is a deeply entrenched common-law principle of testamentary freedom, being the idea that a person of sound mind can dispose of their property as they choose. However, testamentary freedom may be curtailed, by among other things, rights afforded to spouses and other dependants under provincial legislation or contractual obligations of the deceased. In several provinces, a spouse may apply for the division of matrimonial property upon the death of a spouse. For example, in Ontario, a surviving married spouse is entitled to choose between the benefits provided under the deceased spouse's Will or the rights to family property division that would have been available had their marriage ended in separation or divorce. Many provinces also have legislation that provides for the support of dependants, including a spouse, who were not adequately provided for by the deceased in their Will or estate plans.

It is important to note that in certain provinces, some of the rights discussed above may only be afforded to married spouses. Persons entering new common-law relationships should be aware of their respective rights and entitlements as well. The law surrounding the rights of common-law partners is in a state of flux and common-law partners are being afforded more rights than ever before. Consequently, couples entering new common-law relationships should also seek legal advice in revising and preparing their estate plans.

Another potential limitation on testamentary freedom may be an existing support agreement from a previous relationship. A person may be required under a court order or domestic contract to pay support to a former spouse or child. These obligations as well as any other potential restrictions on testamentary freedom must be considered as part of your overall estate plan.

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Income tax implications

Choosing the right asset for the right beneficiary can be a complex task. You may choose assets of equal value for each beneficiary but due to different tax treatments applicable to these assets, the final values may vary, causing inequality between beneficiaries. As such, in deciding which assets to leave to your loved ones, you may wish to consider the income tax implications of leaving your assets to specific beneficiaries. For example, there is a tax advantage in leaving your assets to your spouse, as assets left to a spouse (or a qualified testamentary spousal trust) can rollover on a tax-deferred basis.

Tax minimization should not prevent or deter you from achieving your goals in distributing your estate as you wish. However, there are strategies that may help minimize the tax impact on your death that you may want to consider as part of your estate planning.

Registered assets

RRSP/RRIF

As a general rule, on your death, the fair market value of your RRSP or RRIF is included as income on your final tax return and taxed at your marginal rate. There is an exception to this rule when you designate your spouse as beneficiary of your plan, on the plan documentation or in your Will.[2] When you designate your spouse as beneficiary, your RRSP or RRIF will be wound up and your spouse may transfer the plan assets directly to their own RRSP or RRIF as a tax-deferred rollover. Alternatively, your spouse may transfer the funds in the plan to an issuer to purchase an eligible annuity. In each of these cases, the tax on the amount transferred is deferred until your spouse withdraws the money from their RRSP or RRIF or receives a payment from the annuity.

You are given the additional option of naming your spouse (and only your spouse) as the successor annuitant of your RRIF. When you name your spouse as a successor annuitant, your RRIF continues to exist after your death and

1) Marriage does not revoke a Will in the provinces of Alberta, British Columbia and Quebec.

2) In Quebec, you cannot designate a beneficiary of your registered plans on the plan documentation.

your spouse becomes the annuitant. There is no income tax liability on your death and all payments made out of the RRIF after your death are taxed in your spouse's hands.

It may also be possible to obtain a tax-deferral if you name a qualifying dependent child or grandchild as beneficiary. Special rules also apply where you name a qualifying disabled dependent child or grandchild as the beneficiary of your plan, including the ability to rollover your RRSP or RRIF assets to a Registered Disability Savings Plan for your disabled dependent child or grandchild.

TFSA

You can designate your children as beneficiaries of your TFSA. You may also designate your spouse as either the successor holder or beneficiary of your TFSA. If you designate someone on the plan documentation (not applicable in Quebec), this may simplify estate administration for your executor and minimize probate taxes. You may also be able to minimize probate taxes by naming a successor holder or beneficiary in a certain section of your Will. No matter who you name as the beneficiary of your TFSA, your beneficiary will not have to pay tax on payments made out of the TFSA as long as the total payments do not exceed the fair market value of your TFSA at the date of death. Amounts in excess of the fair market value on the date of death may be taxable to your beneficiary.

Non-registered assets

In general, you are deemed to have disposed of all of your capital property (including your non-registered investments) on your death for fair market value. Even though there is not an actual sale, the deemed disposition may result in a capital gain or a capital loss. The resulting capital gain or loss is included in your final tax return, half of which is taxed at your marginal tax rate.

There is an exception to this deemed disposition rule for property left to your spouse or a qualifying spousal trust. In this case, the property is deemed to rollover to your spouse or spousal trust at your adjusted cost base and any capital gain or loss is deferred until the trust or your spouse disposes of the property (or is deemed to dispose of the property).

Life insurance proceeds

If you own a life insurance policy, the proceeds payable on your death to your named beneficiary or estate are generally not taxable to whomever they are paid.

Probate tax implications

In general, assets passing through your estate on death may be subject to probate taxes. Therefore, you may want to consider strategies where the assets pass

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outside of your estate and are not subject to probate, such as holding your property as joint tenants or naming beneficiaries on registered plans or life insurance policies.

Although probate tax minimization may be one of your goals when estate planning, you may have competing objectives, such as maintaining control over your assets. For example, if you own property in joint tenancy with the right of survivorship with your spouse (not applicable in Quebec), this property will not be subject to probate tax on your death, as the property will pass outside of your estate directly to your surviving spouse. Your spouse, however, will be free to do whatever they choose with this property, including gifting it to their own children and not yours. To protect your children's inheritance, you may want to keep your assets in sole name, and have them pass through your estate on death into a testamentary trust created under your Will. The use of testamentary trusts as an estate planning tool is discussed in more detail later on.

Before implementing any probate avoidance strategies, think about both their benefits and drawbacks and whether the strategy meets your overall estate planning objectives.

Choice of executor

It is important to give adequate consideration to your choice of executor.[3] Should you choose your spouse as executor, or your spouse and children, or a combination of your children from both prior and current relationships? Consider if, and how well, the individuals will be able or willing to work together on the administration of your estate. You may want to think about using a neutral third party to act as executor such as a trust company, lawyer or accountant. While your estate may incur increased costs if a neutral third party is appointed as executor, in the form of executor fees, keep in mind that your estate will also incur significant costs if litigation ensues. Choosing a neutral third party as an executor may help your estate avoid potential litigation.

Estate planning strategies

Having taken into account all of the considerations above, rest assured, there are strategies available to pass wealth on to your children from a previous relationship while still providing for the needs of your surviving spouse. These

3) Estate Trustee with a Will in Ontario; Liquidator in Quebec.

strategies include division of your assets during your lifetime by making outright gifts, establishing alter ego or joint partner trusts, or preparing marriage contracts or mutual Wills. You could also divide your estate assets after death by way of testamentary trusts or life insurance.

Lifetime gifting

Gifting during your lifetime can be a way to minimize probate fees on death, avoid estate administration complications and ensure that an asset goes to the person you intended. In addition, because the gifted assets do not form part of your estate, they may not be subject to any dependents relief or family law claims. Before making any gift, it is important to consider any tax implications that may result from gifting. As well, you should also consider that by making a gift, you will be relinquishing control over the gifted asset, which may not be a desirable outcome to you. Before a gift is made, you should ensure that you do not jeopardize your own lifestyle.

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Inter vivos trusts

As mentioned earlier, courts may be able to interfere with your estate plan should there be any question as to the adequate and equitable distribution of your estate to your spouse and children on your death. If you hold assets outside of your estate, through the creation of an inter vivos trust the assets in the trust may not be available to satisfy a claim for support by your dependant on death under provincial legislation. Note that in some circumstances, a court may use its discretion to set aside an inter vivos gift to a trust if the support claim cannot be met. For further information, speak to your qualified legal advisor.

An added benefit of creating an inter vivos trust is that the assets held in the trust may not be subject to probate tax.

One downside to using an inter vivos trust as an estate planning tool is that for tax purposes, there is generally a disposition of your assets at fair market value at the time you transfer assets to the trust. Any accrued gains on these assets are deemed to be realized at that time and taxable to you at your marginal tax rate. An exception to this tax treatment is where assets are transferred to an alter ego or joint partner trust. In such a case, the assets can be transferred to the trust on a tax-deferred basis.

In order to establish an alter ego trust, you must be 65 years of age or older. The terms of the trust must specify that only you are entitled to the income of the trust and that no one else can receive income or capital from the trust before your death. As the assets are held in a trust during your lifetime, at your death, the assets are distributed based on the terms of the trust document, and not your Will. Accordingly, the assets held in an alter ego trust may not be the subject of any maintenance or support claims made against your estate. Note that in certain circumstances, a court may set aside a transfer of assets to a trust if a maintenance or support claim cannot be satisfied. You may wish to discuss this matter with a qualified legal advisor.

If you are 65 years of age or older and wish to include your spouse as a beneficiary of the trust, you can use a joint partner trust. A joint partner trust differs from an alter ego trust in one respect. Under the terms of the trust, both you and your spouse must be entitled to receive all of the income from the trust until the death of the second spouse. No one else can receive or use any income or capital from the trust before the death of the second spouse. A joint partner trust ensures that your spouse continues to receive the benefit of the assets during their lifetime. Upon the death of the surviving spouse, the assets can be distributed to the beneficiaries named in the trust document, which could be the children of your previous marriage.

While there are several advantages to using these types of trusts, they are not without their drawbacks. It is important to discuss both their benefits and drawbacks with your legal advisor and whether they would be a good strategy to implement in your particular situation.

Marriage contracts

Marriage contracts serve multiple uses, particularly in second marriages. They let you protect your assets and enable you and your new spouse to outline what assets each of you will allocate for your respective children. Equally important, a marriage contract takes precedence over any subsequent Will made by either you or your spouse, effectively governing your affairs in the event of your death. They can also be used to settle legal rights in the event the marriage doesn't work out.

Mutual Wills (not applicable in Quebec)

In a blended family situation, you may want to ensure that both your spouse as well as your children from a previous marriage or relationship are provided for on your death. Leaving your entire estate outright to your spouse on death may be problematic because your spouse is free to leave

those assets to whomever they see fit. They are also free to change their Will at any point and remove any gift to your children that was previously in their Will. Your ultimate gift to your children would therefore not be protected.

Mutual Wills can be used as an effective estate planning tool to deal with this situation. Mutual Wills are based on an explicit agreement between spouses that following the death of one of them, they will not change their Will to defeat their current joint intention. In order for the doctrine of mutual Wills to apply, the agreement for mutual Wills must satisfy the requirements for a binding contract, it must be proven by clear and satisfactory evidence, and it must include an agreement not to revoke the Wills.

If done properly, a mutual Will agreement may prevent a surviving spouse from changing the terms of their Will and disinheriting your surviving children in favour of a new spouse or other beneficiaries. There are risks and problems associated with mutual Wills that should be taken into account. For example, it is difficult to monitor or reprimand a surviving spouse who accelerates spending and depletes the assets of the estate by gifting assets to other family members.

Testamentary trusts

Testamentary trusts are trusts that come into effect upon death, the terms of which are set out in your Will. Testamentary trusts can be used to address and create solutions to complex family situations, such as a second marriage. If you are in a second marriage and you have children from a previous marriage or you have children from different relationships, a testamentary trust may be a suitable vehicle to provide for all your desired beneficiaries who are part of your family. For example, you can create a testamentary trust that provides for your spouse during their lifetime and on your spouse's death, distributes the trust assets to your children from your previous marriage or relationship and not to your spouse's children or heirs. This type of trust is often known and structured as a qualifying testamentary spousal trust.

One of the benefits of establishing a qualifying testamentary spousal trust is that, on your death, you can transfer your assets to the trust on a tax-deferred basis. When you die, you are generally deemed to dispose of all the assets you own at fair market value and your estate is liable for the income tax owing on the capital gains accrued on those assets. However, if the assets are transferred to a testamentary spousal trust at the time of your death, the deemed disposition on death (and the associated tax liability) can be deferred until the assets are either sold or your surviving spouse dies. The trust must provide that only your spouse is entitled to the income of the trust during their lifetime. As well, no one else, other than your spouse may be entitled to the capital of the trust during your spouse's lifetime. When you spouses passes away, your Will can direct that the remaining spousal trust assets be distributed to other beneficiaries, such as your children from your first marriage.

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Your Will, under which the spousal trust is created, might allow the trustee of the spousal trust to encroach on the trust capital for the benefit of your spouse during their lifetime. To protect your children, you may want to consider restricting the trustee's ability to encroach on the capital of the trust, while at the same time ensuring your spouse is adequately provided for during their lifetime.

In general, only assets passing through your estate can be transferred to a testamentary trust. As a result, probate taxes will likely have to be paid on the value of these assets. This is one factor that may be considered prior to setting up a testamentary trust.

Also, keep in mind that your choice of trustee is critical. To avoid tension, you may want to consider an independent trustee. It is essential to discuss this with your legal advisor.

Life insurance

Life insurance is often an important estate planning tool for blended families. Because the proceeds of a life insurance policy will be available on your death, life insurance can effectively serve to create an inheritance to leave to your beneficiaries. Designating your children as the beneficiaries of a life insurance policy may satisfy your obligations to them, thereby freeing up your estate to be left to your spouse.

Conclusion

Estate planning for blended families can be a complex task. It is important to consider your family dynamics and the competing interests of your potential beneficiaries that may cause conflict and possibly lead to litigation. When entering into a new marriage, consider the implications your new relationship may have on your estate plans and be sure to update your documents accordingly. Working with a qualified tax and legal advisor will help ensure your estate plan meets your goals and objectives in providing for your entire family.

This article outlines strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and legal advisor before acting on any of the information in this article.

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