This article originally appeared in Advisor's Edge Magazine in July 2005.

THE EQUALIZER

An advisor reworks a client's will to avoid future challenges, while sorting out corporate ownership and tax issues.

The Advisor of the Year Awards celebrate excellence in helping clients achieve their financial goals. We awarded Robert Radloff an honourable mention for his analysis of a client's ownership stakes in several companies and their effect on his estate planning needs.

By the time Jay James* reached 62, he'd built up a business and acquired interests in another two.

Five years earlier, he married his second wife, Pam, and intended to spend less time at work. To that end, he recently made a 15-year buyout deal to sell his operating company.

His retirement goal was to continue receiving an annual after-tax income of $80,000, which would allow him to give $40,000 annually to charity. He wanted to amend his will to include Pam, 47, and his four children from his previous marriage. The current will directed the bulk of the estate to his son Jack, with lesser sums going to the other beneficiaries.

After an initial analysis of the estate, advisor Robert Radloff identified several family, tax, investment and estate challenges. Jay's inequitable generosity to his children made future conflicts likely. Further, Jay's lion's-share ownership of the appreciating assets meant income was mostly taxed in his hands. The appreciation of his investments, and the plan to leave most of the assets to Jack, would create capital gains issues for the other beneficiaries.

> The will didn't contemplate the use of testamentary trusts to protect heirs.

Over the years, a significant trapped corporate surplus had built up in Jay's holding company (Holdco). They also personally owned a commercial building that had shot up in value and had loans and shares in the two remaining active companies (Active Company 1 and Active Company 2).

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HONOURABLE MENTION

Jay's will was seriously outdated. It left the long-sold operating company to Jack and was ripe for a wills variation challenge from his three daughters. The will didn't contemplate the use of testamentary trusts to protect heirs, nor

*All client names have been changed.

did it provide any tax efficiency. Jay's life insurance and mortgage insurance were temporary in nature, with premiums funded by after-tax dollars.

Most of Jay's assets consisted of the three small businesses, each in the same economic sector and geographic region. Although he had sold the operating company, the 15-year payout schedule placed Jay at risk as a long-term creditor. Active Company 2, in which Jay held a 50% interest, did not have a written shareholders' agreement.

Radloff developed a range of solutions. First, he recommended Jay freeze his holdings in Active Companies 1 and 2 under Section 85 of the Income Tax Act in exchange for a promissory note (representing the value of the frozen assets) and preferred shares (representing the gain).

In addition, he recommended Jay and Pam each roll their interests in the commercial building into the Holdco in exchange for a note equal to the undepreciated capital cost, less the mortgage (representing the frozen value) and preferred shares (representing the gain). He further suggested using a bare trust agreement to avoid property transfer tax. To better facilitate income splitting, Jay and Pam would take back different classes of preferred shares.

The freeze consolidated everything into one corporate entity so the remaining building mortgage could be paid down using corporate dollars. The trapped surplus in Holdco could be released on a tax-free basis through repayment of the notes.

Radloff recommended establishing a family trust to hold the growth shares. It would name Jay, or Pam on his death, and then Jay's children as beneficiaries.

Radloff recommended systematic investment of some of the proceeds from the sale of the operating company in a diversified portfolio.

The terms of the trust would ensure distributions were only made to Jack during Pam's lifetime. Once Jay and Pam were deceased, they'd be directed to also include the other children. To avoid corporate attribution, Pam would only be a contingent beneficiary while Jay was alive. The trust would reduce the likelihood of a wills variation action from the daughters.

In order to transfer taxable income away from Jay, Radloff had Pam move her half interest in the family home to Jay in exchange for an assignment of some of his notes from Holdco. Once Jay received repayment of all the notes, he could redeem the preferred shares.

Radloff recommended converting Jay's mortgage and life insurance into a single $1 million term-to-100 policy owned and funded by Holdco. The benefits of the policy would flow via redemption of preferred shares as a tax-free capital dividend to Pam. To further protect her, Radloff recommended a buy-sell agreement between Jay and Holdco stipulating that on Jay's death, Holdco would redeem all of his remaining preferred shares to Pam using the insurance proceeds and capital dividend account (CDA).

Under the stop-loss tax rules, Pam would receive cash but avoid tax on the value of those preferred shares. Her shares in Holdco from the roll-in of the commercial building would be redeemed in the five years following Jay's death, allowing her to quickly leave the financial picture.

To keep the family at a lower marginal tax rate, Radloff recommended Jay take only the minimum from his RRIF. After death, his registered savings will roll over to Pam tax-free.

The James' holdings also had to be broken up more efficiently, so Radloff recommended systematic investment of some of the proceeds from the sale of the operating company in a diversified portfolio. He also had a buy-sell agreement drawn up for Active Company 2, since it had no signed shareholder agreement.

The wills were redrafted to reflect the new asset structure. To protect beneficiaries from disputes, creditor issues, and to reduce their individual tax, Radloff recommended including provisions for a testamentary spousal trust for Pam and a testamentary trust for Jack. The new estate plan ensured a flow of assets to Pam and Jack.

The payment of insurance premiums with corporate dollars saved 31%, while rolling assets into Holdco created a $1 million note in Jay's hands which would let him extract a $1 million surplus tax-free—a savings of $310,000. The issue of growth shares to the trust is expected to defer an approximate $2 million gain, saving the estate $440,000. It is also anticipated the rollover of $1 million in preferred shares to Pam, employing a CDA redemption, would create tax savings of $220,000 in Jay's estate. **AE**

—*Michael Berton*