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COMMENT

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Planning In A Down Market

Financial planning should take into account the individual's current situation and objectives, with significant events being cues that prompt reviews of that plan. While everyone has different views of what "significant" means, typically such events might include marriage, divorce, separation, a new child or perhaps new grandchild, children's marriage or divorce, a new inheritance or a change in business affairs. Another significant change that some individuals may tend to ignore or downplay, because they are busy or are not sure how to proceed, is a change in the economy.

A significant change in the overall economy can be an ideal time to examine current circumstances and possibly take advantage of some important planning opportunities. The following are some strategies that might be considered in a down market.

Asset securitization: While securing assets should be a planning strategy that is used more often, a down market may provide the necessary urgency to accelerate a review and possibly take action. Planning techniques that accomplish asset securitization include:

- moving non-operating assets, such as cash, out of an operating company and into a holding company by paying a dividend to the holding company;
- causing the operating company to pay out a dividend to the holding company (usually up to its retained earnings) and having the holding company lend back the funds on a secured basis;
- moving real estate and other hard assets out of an operating company into a holding company or a sister company;
- investing non-registered money in segregated funds rather than mutual funds, to create a "floor" value in the event of further market turmoil. If the beneficiary named is a parent, spouse, child or grandchild, there may also be some creditor protection available.

Freeze or refreeze: One of the objectives of an estate freeze is to cap the accrued income tax liability that will arise in an individual's estate (or the second estate in the case of a married couple, depending on planning) by arranging for some of the future growth to accrue to the benefit of one's children. An economic downturn may create the opportunity to place a cap on the current situation or recap a prior estate freeze at a lower level. The objective is to minimize the accrued capital gain and the associated income tax liability on one's own eventual demise by transferring some of it to other family members.

A freeze can be completed with an internal share reorganization or the introduction of a holding company. The new common shares (i.e., the growth shares) could be issued to the children directly or issued to a trust on behalf of the children.

A refreeze should be considered if the current total value of the company is less than the value assigned to the fixed-value preferred shares. In such a situation, the common shares have no value and could be purchased by the preferred shareholder. The preferred shareholder would then complete another freeze at the current value of the company and issue new common shares to the children or a trust on their behalf.

Bad loans: An investor may be able to get some tax relief on debts that have become uncollectible in the year. If the lender is in the business of lending, then the bad loan would be deductible against income. If the loan is to a small business corporation, then the lender may be able to deduct 50 per cent of the loss against income as an "allowable business investment loss." In all other situations, the lender would be restricted to deducting 50 per cent of the bad loan against taxable capital gains.

Personally owned life insurance: While many individuals place their life insurance inside their corporation in order to access lower-taxed dollars to fund premiums, this may not be an effective strategy to protect those policies from creditors. On the other

hand, personally owned life insurance can offer a certain level of creditor protection if the appropriate beneficiary designation is made. Personal ownership also helps avoid possible shareholder benefit charges if the policy subsequently needs to be transferred from the company to the shareholder. The ownership of policies in a holding company may also provide a measure of creditor protection and minimize the likelihood of having to transfer the policy at a later date.

Planning should be an annual event, but may take on a greater sense of urgency upon the occurrence of a significant event like this market downturn.

I/R 2500.00

Proposed Lifetime Benefit Trust

Federal legislation originally introduced in 2005 and subsequently reintroduced in 2007 will provide much-needed relief in estate planning for registered retirement savings plan (RRSP) and registered retirement income fund (RRIF) proceeds when the intended beneficiary is mentally infirm. Unfortunately, this proposed legislation has not yet been reintroduced after the last change in government.

Prior to this proposed legislation, a testator was restricted in planning for an infirm beneficiary. Previously, it usually made sense to set up a trust and have a trustee control and administer the funds on behalf of the disabled person. Not only did this provide care and oversight, in some provinces the use of a carefully designed trust can sometimes help preserve the disabled person's access to important provincial government support and benefits. However, the use of a trust meant that the tax-sheltered status of registered monies could not be maintained. This meant that only non-registered money (including former RRSP and RRIF balances on which the tax had been paid) was available to fund such bequests to a mentally infirm beneficiary. The use of a trust allowed the testator to pick a money manager, a trustee and the ultimate beneficiaries of the capital. If the bequest was left directly to the mentally infirm beneficiary, the issues about control over the funds and ultimate distribution would be left up to the individual or his or her legal guardian.

Upon death, a taxpayer is deemed to have disposed of his or her RRSP or RRIF contracts and the value of the plans is taxable on the terminal tax return. A rollover is available if the payment of the funds to the intended beneficiary qualifies as a "refund of premiums" from an RRSP or a "designated benefit" from a RRIF. In that case, the value of the plan is deductible from the terminal return of the deceased (leaving a net balance of "nil") and the refund of premiums or designated benefit would be taxable to the recipient beneficiary. That beneficiary, in turn, may have available certain rollover provisions that could further defer both the income (to provide long-term support instead of an immediate lump sum) and the consequent tax liability.

The proposed *lifetime benefit trust* allows the testator to better plan for a mentally infirm beneficiary by allowing RRSP and RRIF proceeds to be paid into a qualified trust on the beneficiary's behalf. This allows the testator to choose who will manage the money on behalf of the mentally infirm beneficiary and also on behalf of the beneficiaries who will receive the remaining proceeds on the first beneficiary's death. This simplifies the testator's planning and ensures that the funds will be properly managed.

The proposed rules with respect to the lifetime benefit trust are as follows:

- the lifetime benefit trust is set up under the will of the testator and the trust would be named as the beneficiary of the RRSP and/or RRIF proceeds for the benefit of the mentally infirm beneficiary;
- the beneficiary of the trust must be a spouse or common-law partner or a child or grandchild of the testator and must be mentally infirm and financially dependent upon the testator for support at the time of the testator's death;
- the mentally infirm beneficiary must be the only income and capital beneficiary of the trust during his or her lifetime;
- the trustee must buy a qualifying trust annuity. A qualifying trust annuity is a life annuity (with or without a guarantee period) or a term certain annuity to age 90. Where the beneficiary is a minor child, a term certain annuity to age 18 will also qualify;
- the trustees of the trust must have discretion as to how much income and/or capital they distribute from the trust and must take into account the needs of the beneficiary including his or her comfort, care and maintenance;
- any amount distributed from the lifetime benefit trust to the beneficiary would be fully taxable to the beneficiary and reported on his or her tax return;
- any amount remaining in the trust upon the beneficiary's death would be taxable to the beneficiary;
- any amount remaining in the trust would be distributed as per the trust document to the ultimate beneficiaries as chosen by the testator.

The lifetime benefit trust will be a welcome new estate

planning strategy for individuals with mentally infirm beneficiaries. Due to the complexity of trust planning, anyone planning to implement such a trust should obtain professional legal and tax advice.

I/R 8001.00

Addressing Permanent Life Insurance Needs

Many families start out their insurance portfolios with a large portion of term insurance. This is often an excellent strategy as term insurance is less costly than permanent insurance, especially at a time when larger amounts of insurance coverage are required to meet the financial obligations at critical stages in a family's life cycle and affordability is an important criterion to the purchase decision.

Term insurance is ideal for the temporary needs of the family – those needs that decline or often dissipate over time. For example, it is ideal for ensuring that there is cash available to give the surviving family the option of paying off the family mortgage; providing for long-term education needs of the surviving children; offsetting lost income during income accumulation years after the death of a spouse; or, perhaps, providing financial protection needed to assist an aging parent who survives his or her adult child.

Over time, as a family's needs change, the portion of term insurance in the insurance portfolio can be adjusted. Some or all of the term insurance policies could be converted into permanent insurance. Why might you want to do this? Long-term affordability and long-term needs are two of the most common reasons, and inflation alone can mean that insurance needs do not decrease as much as the family may have initially thought.

The conversion discussion has several facets to address. With term insurance, the cost of coverage rises with the insured person's age because these policies typically have a premium structure that increases every five, 10 or 20 years. In the early stages of the policy, managing the stepped-up premium rates often aligns with the family's increased earning power through the early and mid-life stages. However, as time passes, some families will find that the increasing premium becomes unaffordable.

Term insurance policies that are both renewable and convertible can provide families with the option to convert the policy, without evidence of insurability, from a term insurance structure to a permanent policy under which the premiums become fixed. This conversion option is available up to a maximum age with premiums set on a current-age basis (not the original age at the time the policy was purchased). The benefit of the conversion option is that an individual can move from temporary insurance to permanent insurance without the need to undertake a medical examination to demonstrate insurability.

It is important, however, to keep in mind that a conversion from term to permanent insurance does not increase the amount of coverage. In addition, permanent insurance can appear to be more costly than temporary insurance if looked at in the short term. The question of long-term insurance costs should be measured in the context of the family's enduring insurance needs. Term insurance expires at varying ages depending upon the provisions of the policy. In many cases, age 70, 75 and 80 are common termination ages. If a family has a need for insurance past the expiry age, permanent insurance is the only viable option. Conversion from temporary to permanent insurance at younger ages could mean lower long-term costs and the provision of a minimum coverage guarantee.

Another issue that needs to be considered in the conversion discussion is how much permanent insurance is enough. Term insurance is intended to address temporary needs, so as a family ages and the financial needs change, so does the question of how much insurance is enough.

Consideration also needs to be given to who should be insured. Is it the husband/dad, wife/mom, or both? If both, does insurance on each of their lives, on a joint first-to-die or a joint last-to-die coverage, seem more appropriate to their circumstances?

Consider the following case study:

- Healthy couple aged 52 (Charlie and Roxie Bedford)
- Children are in university or recently graduated
- About 13 years from retirement

The Bedfords need a substantial amount of insurance coverage currently because the surviving family would have need to: (1) continue funding education expenses for the children; (2) provide financial assistance to the children as they each begin their own working/independent lives after completing their education; (3) meet the surviving spouse's capital needs in order to maintain his or her planned standard of post-retirement living; and (4) assist with capital should one of the couple die prematurely during the pre-retirement phase of the family cycle. To complete all of

these objectives, Charlie and Roxie have determined that they are adequately insured with $2.5 million of insurance on Charlie's life and $1.5 million of insurance on Roxie. The difference in the amounts of insurance reflects the different amounts that the couple would expect each to contribute to their family needs over the pre-retirement phase of their life.

At the same time as discussing their current insurance needs, Charlie and Roxie are in discussions about their long-term insurance needs. Up to now, the couple has concentrated on wealth accumulation and ensuring family needs are met. It is their expectation that if they continue their financial plan as it currently stands today, they should be in a position to retire at age 65. If they reach age 65 and retire, what is their permanent insurance need?

1) By age 65, Roxie and Charlie feel they will have addressed the financial needs of their children in respect of education and other financial obligations.

2) They feel that it is important to insure the tax for which they would be liable on their remaining RRSP/RRIF balance. They have worked hard to build their retirement accumulation and feel that their family deserves the full value of any remaining assets.

3) They may want to use life insurance to replace assets lost to supporting one (or both) of the spouses with in-home care, or care in a long-term facility, in the event of debilitating illness. The surviving spouse will need to continue a retirement lifestyle and should not have his or her standard of living negatively impacted by the costs of a nursing home.

4) The couple feels that a premature death will dramatically change the life of the surviving spouse and an injection of some capital will minimize potential financial worries.

While there are many ways to construct a life insurance portfolio, the Bedfords decide to convert $250,000 of their term insurance portfolio on each of their lives to permanent coverage. The funding for the permanent coverage is projected to be complete by the time they retire. This is an important consideration as the couple feel that it is essential that they address the expense associated with maintaining the insurance coverage during their income earning years.

In the design of their permanent coverage, the Bedfords have arranged for the projected death benefit on the permanent coverage to increase over time. While the insurance death benefit may not keep pace with inflation, it was important to the couple to have some level of increasing coverage. They chose this rather than joint last-to-die coverage as they wanted some capital on each death, first for the surviving spouse and second for the family. This aligns with the couple's long-term permanent insurance needs.

The Bedfords' insurance plan provides for the continuation of $3.5 million of total term insurance on their lives – part on his life and part on hers – to address their ongoing temporary insurance needs. The $500,000 of combined permanent insurance provides the couple with the assurance that they will have the needed coverage in their later years when the term insurance is no longer affordable and/or has expired.

The transitioning of the insurance portfolio is easily achieved by converting $500,000 of term insurance to permanent insurance. The only effort required is the paperwork, as no medicals or health questionnaires are necessary. While Charlie and Roxie could wait to undertake this conversion at a point in the future, they opt to do it now when they have the available financial resources and when the premiums are based on their current age (each year they wait, the cost increases).

Having a life insurance portfolio is important to many families and it is equally important to have an advisor who can lead the family through a thorough analysis and conversion discussion.

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