Heritage Law*

Heritage Law Blended Family Estate Planning Package

Fees: $4,500

Blended families are families where one or both spouses (or common-law partners) have been in a previous relationship, and have children from that relationship.

A blended family cries out for pro-active estate planning. The failure to engage in such planning increases the likelihood that someone will seek redress from the courts in the event of incapacity, splitting up or the death of one or both of the parties. Generally speaking, a prudent approach is to hope for and expect the best, but to put in place a plan to guard against the worst. Planning is often centered around the “three Ds”: disability, divorce (or ceasing cohabitation if common law) and death. The documents that should be considered in each of these categories are as follows:

Disability:

1. Powers of Attorney;
2. Representation Agreements;
3. Nominations of Committee; and
4. Living Wills.

Divorce/Splitting Up:

5. Marriage Agreement or Cohabitation Agreement;

Death:

6. Wills (may include spousal trusts).[1]

<u>I. Disability/Incapacity Planning</u>

A **Power of Attorney** is a legal document where you can appoint someone (the attorney) to manage your financial and legal affairs in the event you were unable to do so yourself, for example due to illness, injury or travel. An **Enduring Power of Attorney** remains valid even if the person giving it loses mental capacity. It must be signed before the person loses capacity.

[1] Additional planning options may also be appropriate, including *inter vivos* trusts, beneficiary designations and joint tenancies. After the initial interview, the lawyer will advise if additional strategies are recommended.

A **Representation Agreement** (which is a combined advance health care directive, personal directive and living will) allows you to designate someone you trust to make health and personal care decisions for you should you not be able to make such decisions yourself. If you have any particular health care wishes, you can include them in a Representation Agreement.

A **Nomination of Committee** designates the person that you would want to be your "legal guardian" in the situation where you are no longer mentally capable of making decisions for yourself. According to the *Patients Property Act*, if you have nominated someone to be your committee, the Court must appoint that person to be the "guardian" of your person and your property unless good reason can be shown to the Court why that person should not be appointed. This is a back up document to a Power of Attorney and a Representation Agreement.

A **Living Will** or Health Care Directive generally covers instructions related to refusing life support. Although Living Wills have limited legal effect in BC, there is a requirement for health care providers to follow your pre-expressed wishes in emergency situations. Your Representative (appointed in your Representation Agreement) can confirm that you have not changed your mind and can help ensure the circumstances at hand are the ones you anticipated. A Living Will is a back up document to a Representation Agreement.

II. Divorce/Splitting Up Planning

Marriage Agreements (for Married Spouses)

Division of property between spouses on a marriage breakdown in B.C. is governed by Part 5 of the *Family Relations Act*, R.S.B.C. 1996, c. 128 ("*FRA*"). Without a marriage agreement, assets that qualify as family assets are presumptively owned and divisible equally between spouses. This presumption of equal ownership and division can be rebutted by a spouse who satisfies the Court that an equal division would be unfair, taking into account specific factors listed in s. 65 of the *FRA*.

It is possible for spouses to contract out of the asset division regime under Part 5 of the *FRA* by entering into a marriage agreement. Some typical property division arrangements in marriage agreements, which differ from the division arrangements under the *FRA*, are as follows:

- Parties retain their respective property as separate property during and after the marriage, except for any property which is specifically registered or recorded in joint names, which is divided equally or under Part 5 of the *FRA*;
- All property owned by either party before marriage is kept separate during and after the marriage, but assets acquired by either party during marriage are divided equally, or under Part 5 of the *FRA*;

- All property is kept separate except that a graduated percentage share is acquired over time in property such as the matrimonial home and/or RRSPs by the non-owning spouse (eg. 3% per year to a maximum of 50%); and
- All property is kept separate but there is a graduated lump sum compensation to less affluent spouse on a marriage breakdown instead of a share of property.

Marriage agreements can also include provisions which address issues such as obligations for spousal support and responsibility for living expenses.

Effectiveness of Marriage Agreements

In 2004, the Supreme Court of Canada decided the case of *Hartshorne* v. *Hartshorne*, [2004] 1 S.C.R. 550 ("*Hartshorne*") in which the Court enforced a marriage agreement in a long-term traditional marriage where the wife's entitlement to property was significantly less than what she would have obtained under the *FRA*. The Court emphasized that an agreement does not need to reflect the 50/50 entitlement provided by the *FRA* to be substantively fair.

The Supreme Court of Canada decided that, provided that certain requirements are met, the terms of prenuptial agreements will be enforced in all but the most unusual of cases. The Court reasoned that it should avoid substituting its idea of what is fair for what the parties *believed* would be fair at the time they entered into the agreement. Although the courts do reserve the right to set aside or overrule any terms in a prenuptial agreement which they believe to be unfair, in the post *Hartshorne* environment, courts are less likely to vary prenuptial agreements.

Cohabitation Agreements (for Common Law Partners)

As mentioned above, only married couples can claim for the division of assets under the *FRA*. Since unmarried couples cannot apply for the division of assets under the *FRA*, they can only make a claim against assets owned by the other spouse under the common law of constructive trusts, express trusts or resulting trusts, or under the *Partition of Property Act* if they jointly own real property together.

Trust claims, based on common law, are more difficult to make than claims under legislation such as the *FRA.* If a trust claim is successful, the amount awarded is generally less than what the property award would have been had the couple been legally married and the *FRA* governed. It is possible for common law spouses to contract out of potential common law trust claims for property division by entering into a cohabitation agreement.

Effectiveness of Cohabitation Agreements

Unmarried spouses (people who have lived in a marriage-like relationship for at least two years) can “opt-in” to the *FRA* property division scheme by making an agreement under s. 120.1 of the *FRA*. Some lawyers feel that this section of the *FRA* can be interpreted to mean that the *FRA* property division rules apply to any cohabitation agreement between unmarried spouses, even if the cohabitation agreement specifically provides that the *FRA* does not apply. The risk is that a common law partner, seeking a property award in the future, could ask a court to rely on the more preferential *FRA* rules and find that the cohabitation agreement was unfair.

As a result, there is some uncertainty with respect to whether or not a cohabitating couple should enter into a cohabitation agreement, if the agreement is meant to protect property. Since the *Hartshorne* case noted above, it is less likely that courts will impose *FRA* statutory property rules where a cohabitation agreement itself attempts to preclude a property claim. Of course, the *FRA* property division rules will still apply where a cohabitation agreement indicates that this is what the parties wish.

A cohabitation agreement is also a good option if children are being brought into the relationship, if one party wants to ward against the chance of a spousal support claim when the relationship ends or to deal with allocation of and responsibility for living expenses.

III. Death

A **Will** sets out who you would like to administer your estate, to receive your assets and to be the guardians of your minor children in the event you died. This allows the writer of the will to make these decisions themselves rather than default to the legislative provisions that apply when a person dies without a will. A Will with a testamentary trust provides that all or a portion of your estate assets may be placed into a trust when you die. A testamentary trust may significantly reduce the taxes payable by your beneficiaries on income received from your estate assets.

Estate planning for blended families is difficult due to competing interests: how to leave at least some of your estate to the second spouse, without disinheriting children from a previous relationship. If an estate plan is not structured correctly, there is a risk of litigation and/or an unequal distribution of wealth occurring between branches of a family.

Issues: Assets Left to a New Spouse or Common Law Partner

May people draft mutual wills which state that upon the first spouse or partner to die, everything goes to the surviving spouse or common-law partner, and upon the death of the second spouse or partner, everything is to be divided equally between all of their respective children. In other cases, the couple places all assets in joint ownership with a right of survivorship. This planning is risky for the following reasons:

1. The second spouse may remarry, rendering their previous will void. If they die without a new will, the estate will go by intestacy rules to the second spouses' new spouse and their children only, since the *Estate Administration Act* does not include step-children (i.e. the children of the first spouse to die). Even if they do

sign a new will, the second spouses' new spouse will be entitled to a portion of the estate and the step-children could receive nothing.

2. The second spouse could decide to change their will after the first spouse dies and leave nothing to their step children. Step-children have no recourse or remedy against their step parent under the *Wills Variation Act* of BC.

Issues: Assets Left to Children

Because of a concern that a child from a previous relationship will never see any part of their estate, many parents in blended family situations try to leave money directly to their children. The issues are as follows:

1. A spouse may be entitled to some or all of your estate under common law, the *Family Relations Act* and the *Wills Variation Act* of BC. If you leave money to your children during your lifetime or upon your death, your second spouse may take action to undo or vary these transfers.

2. Some people believe that an existing will leaving assets to children will stand. Unfortunately, if a new will isn't done in contemplation of marriage or right after the second marriage, any previous wills are invalid by virtue of the marriage. If you die without a will, your assets will be distributed according to the *Estate Administration Act* of BC which will provide a significant benefit to the second spouse and may be a very different distribution of assets from what you would wish.

3. Leaving assets directly to your children may result in significant taxes being triggered. When assets are left to a spouse or common law partner, any unrealized capital gains can be deferred until they sell the asset or die. In contrast, when assets are transferred to a child, an unrealized capital gain will usually be triggered on that date (the date of a transfer during your lifetime or upon your death if via a will).

Solutions

A **Spousal Trust Will**, also known as "qualifying spousal trust," is where the spouse or common law partner of the settlor of the trust is entitled to all the income of a trust (and possibly capital) during their lifetime and, second, no other person can receive or otherwise use any of any income or capital from that trust during their lifetime.

Control of the Ultimate Destination of Assets

Spousal trusts are effective conduits to ensure capital passes to the next generation of beneficiaries or to otherwise control the ultimate destination of the capital in the trust. This is particularly important for those in second marriages or common law relationships, with children from first marriages or relationships.

The benefits are that the surviving spouse or common law partner has access to income and/or capital during their lifetime, but when they die the capital will be distributed according to the will of the first spouse, not according to the will of the second spouse to die or the rules of intestacy. This is because the assets never become the property of the surviving spouse – they are the property of the trust. The terms of the spousal trust can provide that upon the death of the surviving spouse, all the assets are to be distributed among the children of the first spouse (or to trusts in favour of those children).

Spousal trusts can be used in conjunction with other solutions to meet your objectives such as leaving some assets directly to your children, insurance, registered investment beneficiary designations and joint tenancies.

If there appears to be a significant risk that a spouse or children will challenge your will or distribution of your estate after the time of your death, and you are at least 65 years old, you may wish to consider using an alter ego or joint partner trust, which are trusts you create during your lifetime which set out the distribution of trust assets at the time of your death.

Tax Avoidance Benefits of Spousal Trusts

There are significant income tax advantages to setting up a qualifying spousal trust (whether created in a will or during someone's lifetime via a trust deed). First, capital assets can be inserted into a spousal trust on a rollover (i.e. tax deferred) basis. Second, the 21 year deemed realization rule does not apply to a qualifying spousal trust during the lifetime of the spouse beneficiary. These advantages provide significant planning opportunities.

Third, testamentary spousal trusts are frequently employed as part of an income splitting strategy to split income and capital gains between the trust and the surviving spouse. The ability to do so exists because the qualifying spousal trust is viewed as a separate taxpayer and it enjoys progressive tax rates due to its testamentary status. For a spouse trust to work well from a tax avoidance perspective, legal ownership of assets needs to be structured so that at least $300,000 of income producing assets will fall into the estate of the testator upon his or her death to adequately fund the spousal trust.

Finally, spousal trust can also be an effective stepping stone to successive trusts. A spousal trust may, by its terms, be divided at the death of the spouse into a collection of successive trusts for the next generation of beneficiaries. That is commonly done when children are involved. If mom dies first, a spouse trust is established for dad. When dad dies, any assets remaining in the trust established by mom for his benefit are then divided into many tax-planned testamentary trusts as there are children. Dad's will does the same thing, and any assets in his name are divided into tax planned trusts for the children. Each of the children ends up with two trusts, one from dad's estate and one from mom's. Because each trust has a different settlor (the person who settles or creates the trust), each trust will attain separate taxpayer status.

This will result in each of the children having the ability to share their income tax liability among three taxpayers who are all taxed at graduated rates (themselves and testamentary trusts from each of their parent's estates). If the trusts are funded properly, that can give the children the opportunity to enjoy more than $100,000 of income at the lowest tax rates at the bottom tax bracket.

Drawbacks of Spousal Trusts

One downside of spousal trusts is that clients must rearrange their affairs so that they each own the assets they wish controlled by the trusts in their name alone. This can involve changing jointly held accounts into separate accounts, changing the designated beneficiary of their RRSPs to "estate" and transferring the house into their names as "tenants in common" from "joint tenants", if these assets are to form part of the spousal trust. This process can take some time and involve some expense.

A second drawback is that probate fees may be payable on some assets on the first to die rather than on the second to die. That said, probate fees are 1.4% of the value of the estate, and the tax reduction offered by a spousal trust can far exceed the probate fees payable.

Example: Spousal Trust in a Will - Income Splitting

A testator dies and leaves an estate of $700,000 to his spouse. The will instrument provides that the funds be contributed to a qualifying spousal trust, with the provision that all income and capital be payable only to his spouse, during the lifetime of that spouse, and the remaining capital to be distributed to his children upon his spouses' death. The $700,000 is invested in fixed interest- bearing securities yielding 5% per annum ($35,000 per annum). The spouse has annual income from other sources of $35,000 per annum as well.

	No Trust	**Spousal Trust**		
	Spouse	**Spouse**	**Trust**	**Total**
Income other sources	$35,000	$35,000		$35,000
Interest on $700,000	$35,000		$35,000	$35,000
Gross income	$70,000	$35,000	$35,000	$70,000
Tax payable by:				
Spouse	$19,484	$5,894		$5,894
Trust			$9,268	$9,268
Total	**$19,484**	$5,894	$9,268	**$15,162**
Net income	**$50,516**			**$54,838**

The spouse will save $4,322 in taxes each year with the spousal trust.