Addressing Debt in Your Estate Plan

Is it better to be a creditor rather than a debtor, or better to collect than to owe? Perhaps in many contexts the answer is yes. For most people, over most stages of life, a debt may be something to avoid and once acquired, it can be a heavy load to have to manage, reduce and extinguish.

For many, being debt-free is the ultimate goal, albeit one that is not easily achieved. However, there are some contexts in which the existence of debt is not a drawback to the debtor. In fact, in some cases carrying debt is deliberate and to the advantage of the debtor. In addition to certain business scenarios where debt is not necessarily negative, or on a personal level where family law and succession law intersect and impact the development of an estate plan, debt may be a strategic choice.

Protecting assets with a Demand Promissory Note

Let's examine one such intersection. Jane and John wish to marry. Jane's family has vast wealth, and as much as her parents respect and love Jane's fiancé John, they are cognizant of today's divorce statistics and wish to take proactive steps to protect Jane's net worth.

Jane's parents wish to give a gift to the newlyweds – a house, to be the couple's Matrimonial Home. Jane's parents are aware of the general rule that gifts and inheritances received during marriage are excluded from division at the time of divorce (so long as there was no mingling of the assets and no transfer of title to both names). They also know that this rule does not apply to the Matrimonial Home of the couple. Furthermore, Jane has informed them that she wishes both names to be on title, thus the home will legally and beneficially belong to both Jane and John, equally.

How can Jane's parents ensure that in the event of a divorce some or all of the value of the Matrimonial Home is excluded from division? The encumbrance of personal debt in the form of a non-interest bearing Demand Promissory Note is an effective strategy to achieve such asset protection.

To implement this, the Promissory Note ("Note") is signed by all parties – the creditor (Parent), and the debtors (Jane and John). In the event of divorce, the value of the Note is deducted from the Fair Market Value of the Matrimonial Home at the date of divorce, and the difference is then divided between Jane and John.

Using this strategy allows Jane to reduce the amount she may otherwise owe John, in any divorce settlement. Further, the debt (i.e., the Note), can be forgiven at any time by the creditor (Parent). More specifically, depending on circumstances and with spousal consent where necessary, it is possible to forgive personal, non-interest bearing loans during lifetime or at death (in the Will) without triggering debt forgiveness taxation. It is important to note, however, that the debt forgiveness rules in the Income Tax Act are complicated, and planning involving debt forgiveness is not to be undertaken without professional tax and legal advice.

Prescribed rate and Shareholder loans

Another example of a strategic 'good debt' is a prescribed rate loan to a Discretionary Family Trust. In this scenario, there is a dual-purpose to the creation of a debt: One is a tax-related objective, to eliminate potential applicability of attribution rules where the beneficiary of the trust is a spouse or a related minor of the creditor, and the other is to protect assets, since the trustee is in control.

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Yet another example, in the right circumstances, may be a shareholder loan. Where the shareholder resides in any province which allows Multiple Wills to operate, it is possible to shelter the amount of the loan payable to the shareholder from provincial probate tax, given the appropriate drafting in the Secondary Will. These types of debt cannot be forgiven during lifetime without triggering negative tax consequences, but rather, these loans must be repaid according to the terms of the loan during the lifetime of the creditor, or, they can be forgiven at death, and thereby being transformed into a bequest or an inheritance.

Is it a gift or a loan?

Occasionally, in situations where perhaps family law, succession law, trust law and contract law intersect, a dispute may arise as to whether a particular transfer of property was a gift, or a loan. The three-pronged legal test for determining whether or not the transfer was a gift, is as follows:

1. There must be a clear and unequivocal intention of the donor (transferor) as evidenced by the donor's behaviour and/or documentation, to make a gift without having received any consideration nor the expectation of receiving any future consideration or remuneration or benefits associated with the transfer of that property to the donee (recipient);
2. There must be physical delivery or transfer of the property from donor to donee, to complete the gifting transaction; and
3. There must be knowledge of, and actual acceptance of, the gifted property by the donee.

If one of the above conditions is not met, the transfer is likely not a gift. While gifting or the transfer of property for no consideration to non-arms' length donees in estate planning is a beneficial strategy to both donor and donee, debt creation between non-arms' length individuals can also be, in the right circumstances, beneficial. In the context of non-arms' length debt creation involving non-interest bearing loans – that is, not commercial loans – the forgiveness of these debts, during the lifetime of the creditor or in his or her Will, does not trigger debt-forgiveness taxation. It is important to note, however, that the debt forgiveness rules under the Income Tax Act are difficult to interpret and to apply, depending on the nuances in the particular circumstances. Where the characterization of the transfer is offside (where the debt is determined to be a commercial loan, namely, where interest is deductible), the negative tax consequences to the forgiven debtor may involve the inclusion of income and taxation of not only the interest payments no longer being paid, but also the entire amount of the loan which was forgiven.

Talk to a professional

Because of the complexities involved with debt forgiveness rules, it is important to consult with a tax and legal professional before entering into any debtor-creditor relationship. For general questions or more information on this article, please speak with your BMO Nesbitt Burns Investment Advisor.

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