

Estate Freezes

Estate freezing is an effective method of minimizing the amount of tax you will pay upon your death. This is because the value of the asset will be frozen at the time of the estate freeze, resulting in future growth being taxed in the hands of the beneficiary.

Since an estate freeze requires you to give up future income and growth on an asset, estate freezes are usually done when you are in your sixties or are comfortable with the value of your estate. If an estate freeze is done too soon, you run the risk of running out of money.

Estate Freezing, The Easiest Way

The simplest way to do an estate freeze is to gift specific assets to your adult children prior to death. This requires you to calculate how much you need to live on in retirement and then determine if you have assets in excess of that. The excess assets can then be gifted to your adult children and future income and growth of the asset will now be taxed in your adult children's hand's.

It is important to note that for tax purposes this gifting will be treated as if you sold these assets at fair market value and therefore if the assets have increased in value you will be subject to tax. In addition, you will have also lost control of these assets and therefore your adult children will be able to do whatever they want with these assets, as the assets are legally theirs.

Estate Freezing, Without Losing Control

If you would like to retain control of the assets in your lifetime, a more formal estate freeze will need to be implemented. A formal estate freeze can be used on a variety of assets including, a portfolio of investments, family businesses or real estate holdings. This type of estate freeze involves either setting up a corporation (if the assets are held personally) or a corporate reorganization of shares (if the assets are currently held in a corporate entity).

How does this work?

The best way to explain a formal estate freeze is through an example. Let us assume:

Mr. Smith, age 60 has a daughter Sarah, age 42

Mr. Smith is the sole owner of a small business corporation, XYZ Corp.

XYZ Corp is currently worth \$1 million and is expected to increase in value substantially over the next 10 years.

Mr. Smith is comfortable with his current net worth and would like any increase in XYZ Corp shares to attribute to Sarah's.

To effectively transfer the future growth of XYZ corp. to Sarah the following steps need to be taken.

Mr. Smith exchanges his XYZ Corp. common shares for 1,000 preferred voting shares with a redemption value of \$1 million. These shares are retractable meaning that at any time Mr. Smith is able to redeem his shares for cash (Due to a special section in the income tax act, this reorganization of shares does not trigger any tax consequences).

Sarah then subscribes for 100 common shares of XYZ Corp at a nominal value (\$1/share)

As a result of this corporate reorganization, any future growth of XYZ Corp. will belong to Sarah, as she owns the common shares of the company. This is because common shareholders retain an equity interest in the company, which entitles them to future profits. On the other hand, preferred shareholders retain an equity interest in the company, which has been fixed at a dollar amount. Mr. Smith's interest in XYZ Corp. has been frozen at the current market value of \$1 million. Because Mr. Smith's preferred shares are voting and he has 1,000 shares (vs. Sarah's 100 shares), he still retains control over XYZ Corp.

Using a Discretionary Trust

If you would like to pass on future growth of an asset to a number of beneficiaries including minor children, a discretionary family trust could be used. Rather than the beneficiaries subscribing directly for the new common shares (as was the case with Sarah in the above example), the family trust would subscribe for the shares.

A discretionary trust would provide protection from the children mismanaging the shares and in addition allow the trustees of the family trust to determine which beneficiaries get which assets and the timing of these distributions.

Seeking Professional Help

It is very important that you speak to your professional advisors prior to undertaking an estate freeze. Your lawyer, accountant and ScotiaMcLeod advisor can help you determine what is ultimately appropriate for you.

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