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Marmer Penner Inc. Newsletter

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Recognizing The End Result Of An Estate Freeze

One of the creations of the *Income Tax Act* (“*ITA*”) is the Estate Freeze. This technique allows the taxpayer to limit capital gains subject to eventual taxation.

Otto owns the shares of Opco which are worth \$500,000. Otto expects these shares to continue to grow in value but dislikes the idea of paying capital gains taxes. Otto knows that on his death, he will be deemed to have sold his shares at fair market value triggering a large capital gain if the shares continue to rise in value. Otto has an infant child. He decides to incorporate a holding company, Holdco. He settles a trust for the benefit of Junior. The trust subscribes for the common shares of Holdco for \$1. Otto uses the provisions of section 85 of the *ITA* to transfer the common shares of Opco into Holdco for \$500,000 of preferred shares of Holdco. The *ITA* allows this transfer to occur on a tax-free basis as Otto has received fair market value consideration, but none of it in cash, debt or other “hard” consideration. All future growth of Opco will now accrue to its new common shareholder, Holdco. Otto’s preferred shares of Holdco are redeemable and retractable at \$500,000, so his value is frozen at this amount. Only the common shareholders of Holdco will benefit from Opco’s growth. Meanwhile, Otto has ensured he may use the \$500,000 lifetime capital gains exemption to avoid capital gains tax on his shares.

Similarly, Otto could have caused Opco to swap his common shares for \$500,000 of preferred shares and issue new common shares to the trust set up for Junior. This is done under the provisions of section 86 of the *ITA*. This achieves the same result as the example above but without the need to incorporate a Holdco.

In both cases, the transferor is left with redeemable and retractable preferred shares and the transferee has common shares with an initial nominal value as all of the business value at date of transfer is effectively owed to the preferred shareholder.

The existence of preferred shares does not guarantee that the common shareholders received their shares by way of an estate freeze. However, the existence of preferred shares with frozen values as evidenced by redeemable and retractable features is a strong indicator that an estate freeze took place earlier. Whether the common shares received by way of an estate freeze are excluded as gifts is a legal matter to be discussed elsewhere.

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Mark your calendars for the upcoming Marmer Penner Inc. Breakfast Seminar on May 25, 2006 from 8:30 a.m. to 10 a.m. Topical issues in family law accounting and taxation will be on the agenda. Breakfast will be served commencing at 8:00 a.m.

This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper professional planning. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at www.marmerpenner.com.