TAX ALERT

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ESTATE PLANNING – A PORTFOLIO FREEZE

Some individuals have investment portfolios considerably in excess of their lifetime needs. People in their mid fifties may have sufficient pensions, RRSPs and other retirement assets (including investment income from their portfolios) to allow them to live through their retirement years without financial worry. Portfolio growth through capital gains may not be needed under almost any situation. However, a substantial part of this growth will be taxed away if steps are not taken to move it to the next generation now.

Let's look at Jones, age 60, with a two million dollar portfolio. She is receiving excellent investment advice and her portfolio should continue to grow in value by about 7% a year – maybe more. Portfolio income has consistently provided an annual return of 3%.

If past trends continue, Jones will have a significant tax liability at the time of her death. How can she fix the value of her portfolio for tax purposes to avoid a significant future tax liability and still have reasonable financial security if things don't work out exactly as planned?

Let's look at an approximate calculation of the tax payable if she does nothing. If her $2,000,000 portfolio increases by 7% a year as predicted, its value will be about $8,500,000 at age 85 – a reasonable approximation of her life expectancy. This will result in a capital gain of almost $6,500,000 on death and income tax of about $1,500,000 on the capital gain. Clearly, Jones should take steps to defer some or all of this tax burden to the next generation.

Jones could accomplish this by first transferring her $2,000,000 portfolio to an investment holding company (Jonesco) in exchange for fixed value special shares and debt from the corporation. Special steps may be required if the current value of the portfolio is significantly in excess of its cost in order to allow a tax free transfer. The newly issued debt and shares can be redeemed by her at any time – say in units of $1,000 to get her initial capital back if necessary. With this redemption of debt and shares and dividends on the shares, there will really be no limit getting funds back allowing her flexibility to meet unexpected future cash needs. This could also increase her eligibility for Old Age Security.

Using a Trust

Jones has three children between ages 30 and 35. Two are married and all have successful careers and are doing well. No problems! Jones intends to treat them equally in the end but wants some flexibility in the meantime. Their marriages seem fine but one never knows.

To complete the plan she agrees to set up a family trust for her children naming them all as discretionary beneficiaries of both capital and income. Jones will be one of the trustees and with two other family members. The terms of the trust provide that it may be wound up at any time by a decision of the trustees but must be wound up within twenty one years. The trust will acquire the common shares of Jonesco for their nominal value of say $100. Although the trust is taxed at the highest personal tax rate, this rate would apply to her anyway had she kept the portfolio in her own name.

The Future

Let's turn the clock forward about twenty years to the time when the trust is wound up or capital distributed. If no significant capital encroachments have occurred, the value of the portfolio will be about $8,500,000 as discussed above. On the winding up of the trust, the portfolio can be transferred to her children (as capital beneficiaries) on a tax free basis. Had Jones kept the portfolio in her own name and its value been realized, she would have had a tax bill of about $1,500,000. The true tax liability now rests with her children who can dip into their portfolios as needs arise. Without this plan, the tax liability on Jones would be payable at the time of her death. Because she did a portfolio freeze, no tax is payable at that time.

Benefits

The main objective of this plan is delay the time when a large part of portfolio growth would otherwise be taxable – probably on Jones' death. Taxes deferred are taxes saved! There could also be current tax savings on trust income paid on capital gains or allocated to children. Another possible benefit to the trust arrangement is that it could protect a child's inheritance in the event of other unforeseen events.

There will be significant amounts of wealth transferred to future generations in the next ten to fifteen years and much of it preserved for family as government support for health, education and other social services declines. Now is the time to start the planning for your family's future needs – delay only make it more expensive.

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