

Larry Jacobson



# Effective Wealth Transfer and Estate Planning for the Small Businessowner

I want to thank *The Scrivener* for the opportunity to present this article, which features information quite different from other financial planning articles published in the magazine.

**T**he classic strategy for wealth transfer for small businessowners is with the use of an “estate freeze.”

It does not use borrowing or the purchase of any financial product.

An estate freeze is a planning technique that minimizes tax liability when transferring wealth to the next generation. The result of the freeze is that the owner’s value is frozen. All future value is generally transferred to a trust for the benefit of the next generation or second generation.

In effect, all common shares (Opco’s shares—growth components of a corporate share structure) are transferred into a new trust so all future growth occurs in the trust, and then all growth of the business is taxed in the next generation. A trust, although not a prerequisite, is used to exercise control over the business; the beneficiaries cannot take premature control.

There are other advantages, but generally you would not undertake that strategy without the expectation of increasing values. Besides businessowners, many investors with large real estate portfolios would

undertake this approach because, historically, real estate has appreciated exponentially to inflation.

Size does matter. The professional fees to implement this could be in excess of \$5000, maybe more, depending on the complexity. I have seen many fees in the \$10,000 to \$15,000 range. Therefore, this should not be considered unless the business or assets were in excess of 4 million dollars.

**Preference or preferred shares do not generally appreciate...**

Another variation for consideration is to establish a new company (Holdco) with the common shares of Opco rolled into it. The trust then owns Holdco’s shares. This strategy can be utilized for income-splitting as well as other financial, tax, and estate planning purposes.

One commonality of all estate freezes is that in the consideration for the transfer of the common shares (no tax impact under the current Act), the owner takes back preferred shares that are retractable and possibly voting. Preference or preferred shares do not generally appreciate, ergo, value is frozen by the value of the preferred shares. This is also known as a diminishing estate freeze. The preferred shares can be then retracted

on an annual basis from the company. (Retraction is a deemed dividend at the par value for tax purposes.)

Therefore, the original owners may no longer take salary and no longer pay double payments into CPP. Their income is purely by way of dividend. With income tax integration, there is not much difference in taxation between salary and dividend, but over the life of the owners, they could—depending on the values frozen—live off the retractions by way of annual dividends. This allows the family to save within the corporate/trust structures, which may have many macro family benefits.

Once we have the estate freeze in place, the value of the preferred shares is known; then the owners will know approximately how much tax will be due upon the death of the survivor of the two spouses.

At this point in the planning process, an insurance agent may be required—to purchase a joint and last survivor insurance policy (declining term to match the declining values of the preferred shares if retracted annually), if liquidity is an issue. In this manner, upon the death of the last spouse, or if both spouses are hit by a bus the same day, the estate would be guaranteed to have enough liquid capital to pay the amount of income tax due on the remaining value of preferred shares.

As an aside, the insurance might be owned corporately, because the payout is tax free through its capital dividend account.

Wealth transfer need not stop there. Estate planning must be taken into consideration to continue the process.

How do you leave an estate to a blended family? Certain testators may want to leave more wealth to one set of children than another set of children, and that could trigger an action under *Wills Variation Act*. There are ways to plan. Of course, you can transfer all your assets into an inter vivos trust.

The negative? In this scenario there is a disposition of the assets upon transferring to the trust, and taxes must be paid. Generally not a wise choice.

Another option, though age-dependent, is to set up an alter ego trust or joint partnership trust that provides the individuals the opportunity to create this inter vivos trust (lifetime trust) on a tax-free rollover basis.

That has a number of advantages.

First, all the assets are no longer part of your estate—when you die, the assets held within that special type of inter vivos trust are not probated, ergo, no probate fees are paid on the transfer.

Second, the assets are not made public and are not subject to the *Wills Variation Act*.

Third, this process has stood the test of litigation by a disgruntled beneficiary.

For example, if there is a second marriage involved and you felt the new spouse is less deserving of some of your assets than your children, that can all be handled through the alter ego trust. The main details of an alter ego trust are as follows.

### **Alter Ego Trusts**

- a. The trust is created anytime after 1999.
- b. The settlor, or the person who is transferring in the assets, must be 65 years or older at the time the trust is created.

- c. Both the trust and the settlor are Canadian residents.
- d. The settlor is entitled to receive all of the income of the trust arising before death.

With whom should you discuss this? The first person is a professional financial advisor who can assess your total situation and help you determine long-term strategy. After a review, the advisor—if necessary—will refer you to a tax planner who practises, exclusively, law in the highly specialized area of estate planning, especially if you are in a second (or third, etc.) marriage. For a list of RFP advisors, go to [www.iafp.ca](http://www.iafp.ca).

Are you a BC Notary nearing retirement? I am offering one free financial makeover to look at your current situation and demonstrate how to achieve your goals. We will publish your financial information with my comments in the magazine, and conceal your identity. Please contact me in strictest confidence. ▲

Vancouver native **Larry Jacobson** received his Diploma of Technology (Administration and Finance) from BCIT in 1971. He joined Macdonald, Shymko and Co. in 1975 and became a principal in 1976. He obtained his BC Notary Public designation in 1978, but dropped it in the late 1990s to focus exclusively on financial planning with high-net-worth individuals. Larry holds the RFP designation, the highest and most prestigious designation in the financial planning profession within Canada, and a Master's degree in Business Administration (International Management).

He has held executive positions in many financial planning associations and now focuses his volunteer time exclusively to the Association of Advanced Financial Planning as Chair of the Board of Directors. The proud father of two sons, Larry is an avid bridge player working on his Life Master designation. He enjoys baseball and football and has been a BC Lions season ticket holder for over 35 years.

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