

# NEWSLETTER

## The Freehold Owners Association (“FHOA”)

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## ESTATE PLANNING FOR FREEHOLD MINERALS

In 1798, Benjamin Franklin wrote: “Nothing is certain but death and taxes.” None of us can avoid the former, but if we understand how mineral interests are taxed we may be able to minimize the latter. This issue of your newsletter focusses on the taxation of freehold mineral interests in the particular context of estate planning.

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### ANNUAL MEETING

The Annual Meeting of the Freehold Owners Association, which was held in Edmonton on April 20, 2002, was attended by approximately 350 members and guests. Elected as directors of the Freehold Owners Association for 2002 were:

Mr. Richard Anderson of Eckville, Alberta;

Mr. Don Beddoes of Crossfield, Alberta;

Mrs. Gloria Delisle of Innisfail, Alberta;

Mr. Jim Hampton of Grand Forks, British Columbia;

Mr. Jim Harriman of Calgary, Alberta;

Mr. Keith Luft of Cochrane, Alberta;

Mrs. Else Pedersen of Ponoka, Alberta,

Mr. Jack Pearse of Namao, Alberta;

Mr. Richard Riggins of Ottawa, Ontario;

Mr. Keith Wilson of Edmonton, Alberta; and

Mr. Deryk Ziegler of Vegreville, Alberta.

Mrs. Else Pedersen was elected as President of the Association.

The minutes of the Annual Meeting have been posted on FHOA’s web site and will be mailed to interested members upon request. Many thanks to those members who volunteered their time to help make the Annual Meeting a success.

Membership in the Association

continues to grow. More than 1700 freehold owners have now joined FHOA.

The problems we face as freehold mineral owners are many and varied - late royalty payments, incomprehensible royalty statements, excessive deductions from our royalties, gas price manipulation, drainage of our property from off-target wells on our fence lines, shut-in wells maintaining our leases for decades, ‘mis-allocation’ of our gas to the petroleum owner in split title situations, etc. As individual citizens, most of us lack the technical and legal training to fully understand these problems. Even if we have the financial resources to hire professionals to help us, we oftentimes find that the incomprehensible ‘legalize’ in our freehold lease agreements actually authorizes the unfair treatment we receive.

All members are urged to ‘spread the word’ about FHOA. Together, through a strong and growing association of freehold owners, we can make a difference and force change. Help us to help you.

### RECENT ACTIVITIES

#### Education and Information:

Knowledge is power and providing education and information to freehold owners remains one of your Association’s primary objectives. FHOA is attempting to achieve this

objective by conducting information seminars, by providing newsletters and a comprehensive web site, by answering your telephone and e-mail queries, and by providing technical information pertinent to your mineral interests for a modest fee.

#### **Seminars:**

To date in 2002, *FHOA* has held information seminars in Namao, Edmonton and Stettler. **Our next seminar is planned for the Highwood Memorial Centre in High River at 7:00 p.m. on November 26, 2002.** Mr. Keith Luft, an experienced oil and gas lawyer and member of the Association's board of directors will be the principle speaker. A question and answer session will follow Mr. Luft's presentation. Admission is \$5 per person or couple. Advertising is expensive so help to support your association by spreading the word about this seminar to friends and neighbours who may own freehold minerals.

We recognize that many of our members live too far away to attend these seminars. *FHOA* has plans to make videotapes of information presented at these seminars available to members for a modest fee. Further information on this initiative should be available by year end.

The success of our seminars to date is due, in part, to the assistance provided by the Freehold Mineral Tax Division of Alberta Energy and the Office of the Farmers' Advocate of Alberta. The Association gratefully acknowledges these contributions and, in 2002, the assistance provided by the Namao Agricultural Society, the County of Stettler, the Stettler Agricultural Society and Mr. Robert Krejci, C.A.. We also thank those individuals who volunteer their time to help us organize these seminars.

If you would like an information seminar in your area of Alberta and are prepared to help with organization, please contact our offices.

#### **Web Site:**

Traffic on the association's web site has now increased to more than 500 visitors per month. The association intends to upgrade the site by adding information on taxation and estate planning for freehold mineral owners. *FHOA* also has plans to add selected video clips to the site to illustrate some of the more common problems encountered by freehold owners.

#### **Technical Service Requests:**

In 2001, the association acquired a subscription to a technical database and began to make basic technical information respecting members' mineral rights available to them for a modest fee of \$50. Information which is provided consists of maps showing the status and production from all of the wells in the nine sections including and surrounding the section containing your minerals, a well summary report for all wells licensed, drilled or drilled within the area, a well production report summarizing the production from these wells, and a land map showing Crown and freehold lands within the area. The land map includes bonus prices paid for any Crown leases in the area together with the dates that the particular Crown land was leased.

This service has proven to be very popular with members. Following the Association's annual meeting, our offices were swamped with requests for technical information. Regrettably, this resulted in significant delays in filling member requests. We apologize to those members who, in some instances, have waited many months for the information requested.

The Association recognizes that to be

useful to members technical information must be provided in a timely manner. *FHOA* is currently investigating opportunities to secure additional funding which would allow us to hire administrative staff and fill these requests within a two week period. In the interim, we have now worked through most of the backlog of requests and expect to be able to fill future requests in a more timely manner.

#### **Other Initiatives**

##### **Freehold Lease & Royalty Statement Database:**

To date, approximately 100 members have provided the Association with copies of their lease agreements and/or royalty statements.

During the summer, a university law student, hired under a federal government salary matching program, categorized the lease agreements. Although the number of leases in the database does not yet warrant any statistically meaningful conclusions, it is apparent from the data that a number of land agents in Alberta continue to use CAPL 88 lease forms. These lease forms have been discredited for more than a decade. *FHOA* encourages members who are approached by land agents to sign a CAPL 88 lease to advise our offices of the name of the land company involved.

The royalty statements provided show significant variations in the level of disclosure. Some operators provide full particulars of how royalties have been calculated in a format which a layman can understand. Others provide reasonably detailed information but in a format which can only be understood by an industry professional. Still others provide no information whatsoever. The royalty statements provided to date clearly demonstrate the need for standardization in industry freehold

royalty reporting practices and procedures.

Where the reported information can be understood, different operators report significantly different gas sales prices and processing deductions for the same period. Some variation is to be expected, but the data provided to date suggests that certain operators may be manipulating their gas contracts so as to allocate low priced gas to freehold owners.

*FHOA* needs more data if it is to address the many problems associated with the existing freehold leases and industry royalty statements practices. If you have not done so already, please give consideration to providing our offices with copies of your lease agreement and representative statements.

#### **Agri-Trade Exhibition:**

In an effort to make more freehold owners aware of the existence of our association and to provide members with an opportunity to ask questions, the Freehold Owners Association has booked a booth at the Agri-Trade Agricultural Exhibition to be held in Red Deer from November 6 - 9, 2002. If you attend this agricultural exhibition, stop by and introduce yourself. Our booth will be in the Centrium Foyer (Booth 1404).

## **FREEHOLD MINERAL TAXATION**

The comments that follow are an attempt to simplify complex matters and are intended to provide members with general information. In some instances, simplification has resulted in a non-rigorous treatment. **These comments are not intended to be a substitute for professional advice.**

#### **Federal Taxation:**

Freehold minerals owned by individuals or corporations are considered to be 'Canadian resource property' for purposes of the Canadian Income Tax Act (the "Act"). A number of the tax rules applicable to Canadian resource property are particularly important in estate planning.

Firstly, payments received from Canadian resource property are taxed as income. Expenses incurred in exploring, developing or acquiring a Canadian resource property may be deducted from income. These deductions are accomplished through 'tax pools'. Freeholders typically lease their freehold mineral interests to an oil company and, because all exploratory and development expenses are incurred by the oil company, tax pools known as Canadian Exploration Expense ("CEE") and Canadian Development Expense ("CDE") are usually not relevant to freehold owners. But freehold owners may incur expenses in acquiring Canadian resource property. Costs incurred to acquire an interest in freehold minerals are included in an individual's Canadian Oil and Gas Property Expense ("COGPE") pool in the year of acquisition. Generally, the amounts in your COGPE pool may be deducted from your income on a 10% declining balance basis (for example, if your freehold mineral interests were acquired for \$10,000, you could deduct \$1,000 from your income in the first year, \$900 in the second, \$810 in the third, etc.). The foregoing applies irrespective of whether you actually purchased the freehold minerals for cash or inherited them through an estate in which tax was paid under the deemed disposition rules (see below).

#### **Taxation of Lease Bonuses, Rentals and Royalties:**

The cash signing bonus you receive when you lease your freehold mineral interests and

the payments you receive as annual delay rentals or shut-in royalties are considered to be proceeds of disposition of a Canadian resource property by the Canada Customs and Revenue Agency. To the extent that these amounts exceed the amount in your COGPE pool, they should be declared as income in the year of receipt. In the above example where you acquired the freehold mineral interests for \$10,000, if you received a \$16,000 signing bonus in the year of acquisition, you would reduce your COGPE pool to zero and include \$6,000 in income. If however your signing bonus was only \$9,000, you would reduce your COGPE pool to \$1,000 and have no income for tax purposes as a result of leasing. In situations where freehold owners acquired their mineral interests for token consideration many years ago, all amounts received as lease signing bonuses or delay rentals are effectively income and COGPE pools are relevant only in the context of estate planning.

Because freehold mineral interests are Canadian resource property and not capital property, the capital gains rules do not apply. The proceeds from an outright sale of your freehold mineral interests are treated in the same way under the Act as leasing proceeds and delay rentals or shut-in royalty payments. To the extent the proceeds from a sale of your mineral interests exceed the amount in your COGPE pool, the proceeds should be included in income. In the above example where you acquired the freehold mineral interests for \$10,000, leased them for \$9,000 thereby reducing your COGPE pool to \$1,000 and then, for instance, sold them that same year for \$15,000, you would reduce your COGPE pool to zero and have income of \$14,000 in that year.

Any royalty payments you receive under terms of your lease agreement are considered to be investment income by the Canada Customs and Revenue Agency. The Act requires

your oil company-lessee to provide you with a T-5 slip each spring indicating the total amount of royalties from Canadian sources received by you in the prior year. In certain provinces, including Alberta, freehold owners must pay freehold mineral tax to the province on production from their mineral interests (see below). Provincial freehold mineral taxes are not deductible for federal income tax purposes. To compensate for this, the Canada Customs and Revenue Agency allows freehold owners a resource allowance deduction which is effectively equal to 25% of royalty payments received. The Act requires oil companies to report the amount eligible for resource allowance on the T-5 slips which are provided to you, but some oil companies fail to comply with this requirement. If the amount shown in box 20 of your T-5 slip (Amount eligible for resource allowance deduction) does not correspond to the amount shown in box 17 (Royalties from Canadian sources), FHOA recommends that you contact the oil company and request an explanation.

In addition to resource allowance, you can also deduct expenses directly related to income earned from your freehold mineral interests. For example, if you hired a consultant to assist you in negotiating your lease, the consultant's retainer may be deducted from your lease signing bonus payment. Similarly, if you hire a consultant to review your royalty statements, the consultant's retainer may be deductible from your royalty payments.

As a consequence of the treatment of income from your mineral interests under Canadian income tax legislation, your tax liability for lease signing bonus payments, delay rental or shut-in royalty payments, and royalty payments from your freehold minerals in any year will be determined by your overall income

level in that year.

#### **Deemed Dispositions:**

**T**he deemed disposition rules are particularly important in estate planning involving freehold mineral rights. Under the Act, an individual is deemed to have disposed of all of his or her Canadian resource property immediately before death for proceeds equal to the property's fair market value. There are provisions in the Act which allow you to leave your freehold mineral interests to your spouse, your common law partner or a spousal trust on a tax-free basis, but if you intend to leave your mineral interests to someone else, the deemed disposition rule may create a tax liability in your estate. Depending on the fair market value of your minerals (see below), this tax liability may be onerous.

#### **Valuations of Freehold Minerals:**

**T**he Canadian resource properties leased by oil companies are evaluated on a regular basis in conjunction with oil and gas industry mergers and acquisitions, and to satisfy the corporate reserve reporting requirements of securities regulators. An entire 'sub-industry' of evaluators exists to provide independent evaluations to the oil and gas industry. If no wells capable of production have been drilled on or in the vicinity of a property, evaluators typically base their evaluations on the price paid for comparable Crown leases in the area. If wells capable of production exist, valuations are based on: estimates of the volumes of oil and gas in place; estimates of the volumes of oil and gas which can be recovered; estimates of the future prices of oil and gas; and estimates of the future costs to produce the oil and gas, including taxes and royalties. Individual evaluators seldom agree on all of these variables and, if they do, they are usually all wrong. Consequently the estimated

value of any particular Canadian resource property leased by an oil company may vary widely.

Freehold mineral interests are even more difficult to evaluate.

One reason is that you own your mineral interests in fee simple whereas oil companies merely lease fee simple interests. This means that your property rights are not limited by time - you, or your beneficiaries, are the owners of any oil or gas found beneath your lands no matter when it is found. Your interest differs from an oil company's interest as the property rights which an oil company acquires when it enters into a lease agreement terminate when the lease expires. This distinction is critical from a valuation standpoint because drilling and abandoning a nine inch well bore on a quarter section of land does not prove that the entire quarter section has no oil or gas, especially if the well bore is not deep enough to evaluate all potentially productive geological zones. Furthermore, there are countless examples of situations where oil companies have drilled and abandoned wells many years ago, when prices were lower and technology was less advanced, which would not be abandoned today. The oil companies' property rights have long since expired, but the fee simple owners' have not. From a practical standpoint, this results in evaluations of freehold mineral interests being inherently even more uncertain than evaluations of the lease rights of oil companies.

An evaluation of the fair market value of a 'simple' producing freehold property by one of the major evaluation firms in Calgary may be expected to cost between \$1,000 and \$2,500. If the mineral rights are not leased, or if they are leased but not producing, the cost of a professional evaluation may be less. The evaluation of more complex freehold properties (for instance, properties

subject to a unit agreement) may be significantly more expensive.

In situations where freehold mineral interests are generating minimal annual royalties, it may be difficult to economically justify the cost of a professional evaluation of the property's fair market value. One 'rule of thumb' which may be used in these situations is to apply a multiple of three to five times the average annual royalty received from the property. For instance, if freehold mineral interests had been generating an average of \$2,000 per year for a deceased individual, a fair market value in the range of \$6,000 to \$10,000 may be reasonable. If the annual royalties received had been increasing year over year, you would use the higher number and vice versa. Under Canadian income tax legislation, the deceased individual would be deemed to have received proceeds of disposition equal to this fair market value immediately before his or her death, and this amount would effectively be brought into income in the year of death (assuming the individual's COGPE pool was zero).

Oil and gas prices have swung widely in recent years and this has had a significant impact on the royalties received on an annual basis by many freeholders. In addition, the de-regulation of gas markets has resulted in gas production from many recently completed wells declining more rapidly than previously. As a result, royalties received over the past several years may not be indicative of what may be received in the future.

The Canada Customs and Revenue Agency takes the position that fair market value estimates must be reasonable. If the freehold mineral rights generate more than token annual royalties, *FHOA* recommends using qualified evaluators to determine fair market value in order to protect against possible future

audit. Whatever method you use, document it and keep it on file.

### **Provincial Taxation:**

**I**n addition to the provincial share of income tax generated by freehold minerals, certain provinces levy a tax on production from freehold minerals.

### **Freehold Mineral Tax:**

**I**n Alberta, the Freehold Mineral Tax Act provides for an annual tax to be levied by the Provincial Government on production from freehold mineral interests in the year following production. Separate taxes are levied on petroleum, solution gas, natural gas and condensate. Although the formulae used to calculate the freehold mineral tax are complex, their effect is to charge a tax of approximately 7% of the total value of production in the prior year. The value of production is based on oil company submissions which are subject to audit by Alberta Energy. The legislation provides for an exemption of up to \$3,200 per mineral title for each of petroleum and natural gas. Where title is split, the petroleum owner may receive an exemption of \$3,200 per title (\$1,600 for each of petroleum and solution gas) and the natural gas owner may receive an exemption of \$1,600 per title for natural gas.

Most freehold leases provide for the freehold mineral tax levy to be shared between the oil company-lessee and the freehold owner-lessor in proportion to their interests. For example, if you negotiated an 18% royalty rate, the oil company would be responsible for 82% of the freehold mineral tax and you would be responsible for 18%. This sharing ratio is no more sacrosanct than anything else in a freehold lease. It may be in your best interests in leasing your minerals to attempt to negotiate a reduced sharing ratio. Completely

eliminating your share of freehold mineral tax is not recommended as this would impact your resource allowance claim.

Although the responsibility for payment of freehold mineral tax under the Alberta Freehold Mineral Tax Act rests with the freehold owner and non-payment may ultimately result in cancellation of a freehold owner's title, the oil company-lessee typically pays both its own and your share of the freehold mineral tax and deducts your share from future royalty payments.

In Saskatchewan, the payment of freehold mineral tax is the responsibility of the oil company-lessee and freehold owners cannot claim resource allowance.

## **ESTATE PLANNING**

### **What is Estate Planning:**

**T**he general purpose of an estate plan is to organize your personal affairs so as to preserve your wealth. An estate plan typically involves structuring your Will so that, when you die, your assets will pass in the most advantageous manner possible to those whom you have chosen to be the beneficiaries of your estate. An estate plan may also involve splitting income with other family members while you are alive so as to reduce your family's overall tax bill.

### **Who Needs an Estate Plan:**

**O**ur eventual demise is certain and, because conversations from the grave are so difficult, we all need an estate plan. The timing of our death is not certain, therefore the time to consider estate planning is now.

### **Setting Your Objectives:**

**A**s we make our way through life, our circumstances change. At different times we may have a dependent spouse, dependent children, dependent parents or others who rely on us for financial support. Typically, during our earning years our dependents become more self-sufficient and our ability to accumulate wealth increases. Who we want to inherit our wealth may also change as circumstances change. That is why it is so important to have an up-to-date Will. There may also come a time when we have accumulated more wealth than is necessary for our individual future needs, and structuring an estate plan to distribute excess wealth to our beneficiaries during our lifetimes may be something worth considering.

### **Professional Help:**

**E**ven the simplest Will can involve complex legal and tax matters. When your assets include mineral rights, further complexities arise. People are unique and so are their estate planning objectives. The Freehold Owners Association strongly recommends that all of its members retain competent professionals to assist them in structuring an estate plan. The following comments are intended to assist you in recognizing the merits of estate planning and are no substitute for professional advice

### **Relevant Factors in Estate Planning for Freehold Minerals:**

#### **Fractionation of Interests:**

**H**istorically, freehold mineral interests have typically been transferred from one generation to the next equally amongst the heirs. In situations where succeeding generations have large families, the freehold mineral

interests rapidly become fractionated. Excess fractionation may effectively destroy the value of your freehold mineral interests.

The problem relates, in part, to today's mobile society in which family members often become dispersed around the world. Oil companies typically retain land agents to negotiate freehold lease agreements. In situations where a single freehold property is held by a large number of individuals living in different areas, the oil company may spend more in land agent fees than on actual lease bonus payments. Clearly, the less an oil company pays in land agent fees, the more money the company has available to pay the freeholder for a lease.

Fractionation of freehold mineral interests also gives rise to other practical problems for an oil company. In order to conduct oilfield operations on freehold mineral interests, an oil company must secure lease rights from all owners of the property or face lengthy and costly hearings under the forced pooling provisions of the Oil and Gas Conservation Act. As the number of individuals on title increases, the chance that all family members will agree to the same lease terms decreases. Nine signed leases on a property with ten freehold owners is the type of problem most oil companies would prefer to avoid. Some companies have policies which prohibit their staff from dealing with freehold mineral interests where there are more than a certain number of titleholders.

#### **Land Titles Acts:**

**I**n addition to the practical problems presented by the fractionation of freehold mineral interests, under the Alberta Land Titles Act, the Registrar may refuse to register a transfer which gives rise to an undivided fractional interest in

minerals which is less than an undivided 1/20th of the whole interest. Most of the freehold owners in Alberta are the descendants of settlers who acquired their mineral interests at the turn of the last century as part of their homestead lands. In many cases, these mineral interests have now passed through three or four generations. Members of the current generation will increasingly be forced to address the issue of legal registration of title. In Saskatchewan, the problem is more severe because the Saskatchewan Land Titles Act authorizes the Registrar to refuse to register any instrument that disposes of an undivided fractional interest that is less than 1/4th of the whole.

### **Negotiation Strategies:**

**A**lthough having a large number of individuals on title to the same freehold property is generally not a good idea because it may reduce your leasing opportunities, there is merit to having more than one owner. More than one owner may allow your family to engage in 'good cop - bad cop' negotiating strategies with land agents.

### **Taxation Issues:**

**U**nder the Income Tax Act, individuals and corporations may be subject to significantly different income tax levies on the same amount of income (see below).

Freehold mineral tax should also be considered in estate planning. In Alberta, an exemption of up to \$3,200 per year in freehold mineral tax may be available to each title owner. Transferring freehold mineral interests to a single legal entity, such as a corporation, rather than to individual beneficiaries may result in an effective increase in future liabilities for freehold mineral tax.

## **Options to Consider:**

A great many factors must be considered in structuring an estate plan involving freehold mineral interests. There are no simple answers and the use of qualified tax and legal experts is highly recommended.

### **Transfer to a Corporation:**

One strategy that may be used by families to resolve the issue of title fractionation is to incorporate a company and transfer the freehold mineral interests to the corporation. Even if the mineral interests have significant value, such a transfer can usually be accomplished on a tax-free roll-over basis under the provisions of section 85 of the Income Tax Act. Upon such a transfer, the corporation acquires legal ownership of the freehold mineral interests and title is registered in the name of the corporation in the land titles registry.

Typically, it is the shares of the corporation which you leave to your beneficiaries, not partial interests in your freehold minerals. This prevents further fractionation of title and allows oil companies interested in the mineral interests to deal with a single entity - the corporation.

Transferring your mineral interest to a corporation may have the disadvantage of creating additional income tax liabilities. Income received from freehold mineral interests does not qualify as 'active business income' and, in most cases, the corporation will not qualify for the reduced tax rate applicable to the first \$200,000 of active business income. Depending on your own marginal tax rate and the marginal tax rates of the other shareholders in the corporation, the same freehold mineral income may give rise to a significantly greater income tax liability at the corporate level than

would otherwise have been payable.

Transferring your mineral interests to a corporation also has the disadvantage of minimizing the Alberta freehold mineral tax exemption.

There are also costs involved in creating and running an corporation. In addition to incorporation costs, there are annual filing fees and the costs of preparing financial statements and filing corporate income tax returns.

Creating a company to own our freehold mineral interests and then leaving shares in that company to our children may give rise to future conflicts among your children. Had you left fractional interests in the freehold minerals directly to your children, they would each be free to deal with their individual interests in the minerals as they saw fit. The corporate structure requires a uniform approach to matters such as leasing. If you transfer your freehold minerals to a corporation, it is recommended that a unanimous shareholder agreement be executed. This type of agreement provides a mechanism for the reasonable resolution of disputes amongst shareholders.

### **Estate Freeze:**

One of the more significant advantages of transferring freehold mineral interests to a corporation is the opportunity to 'freeze' the value of the freeholder's interest in the property and allow future growth to accrue to other shareholders in the corporation.

In its simplest form, an estate freeze may be accomplished by having a parent transfer his (or her) freehold mineral interests into a corporation and taking back preferred shares with a value equal to the fair market value of the freehold minerals. Common shares in the corporation are issued to

the owner's children or grandchildren.

Future royalties which accrue to the corporation may then be used to redeem the preferred shares providing the parent with a revenue stream during his lifetime. Any increase in the fair market value of the freehold mineral interest will accrue to the common shares.

This not only has the effect of spreading the tax liability associated with the preferred shares over a number of years, it minimizes the tax impact in the parent's estate. Instead of being taxed on the deemed disposition of the freehold mineral interests at fair market value immediately before the parent's death, tax is calculated on the value of the parent's preferred shares which have not been redeemed.

Caution must be exercised in structuring an estate freeze in order to ensure that the attribution and benefit provisions of the Income Tax Act do not apply. Professional assistance is essential.

### **Transfer to a Trust:**

In simple terms, a trust is created when there is a legal obligation placed on a person (the 'Trustee') to control and deal with certain property (the 'Trust Property') for the benefit of a person or persons (the 'Beneficiaries'). The Trustee must act according to the terms and conditions specified by the person who set up the trust (the 'Settlor').

In the case of freehold minerals, 'family trusts' may be used to split income from mineral rights amongst family members. The concept is to transfer income from one family member to other members of the family thereby reducing the overall income tax paid. The Settlor is typically the parent who owns the mineral interests which become the Trust Property. The Beneficiaries are

usually the owner, his spouse and children or grandchildren. A family member, a professional trustee, a legal firm, or an accounting firm may be chosen to be Trustee.

Setting up a family trust to hold freehold minerals may be quite expensive. Firstly, the transfer into the trust of the freehold minerals gives rise to a disposition in the freehold owner's hands in an amount equal to the fair market value of the minerals. In addition to the income tax payable by the freehold owner on the disposition, it is essential that a professional evaluation of fair market value be obtained.

Once structured, a family trust holding freehold minerals provides considerable flexibility in allocating income from the mineral interests in a tax advantageous manner.

A trust may also be utilized in combination with a transfer to a corporation to accomplish both an estate freeze and income splitting.

A number of complex income tax rules, including the '21-year rule', which essentially deems a trust to have disposed of its property every twenty-one years, must be addressed in structuring a trust to hold freehold mineral interests. Once the trust is structured, it is necessary to maintain records, and file trust tax returns and beneficiary elections. Professional tax and legal advice is essential.

Due to the costs associated with structuring and maintaining a family trust holding freehold mineral interests, the trust structure is typically only applicable to situations where significant royalties are being generated by the mineral interests.

#### **Transfer to Children:**

**I**f fractionation of title is not an issue, a strategy which may be implemented by a parent is to

transfer ownership of the freehold mineral interest to his or her children during the parent's lifetime. The transaction will give rise to a disposition and the parent will be subject to income tax on the fair market value of the freehold mineral interest at the time of the transfer. This works best if the mineral interests have nominal value because they are not leased or, if leased, not producing. If the freehold minerals are leased and developed in the future, the children will benefit from the increased value and taxes in the parent's estate associated with deemed disposition of the mineral interests will be eliminated.

#### **Summary:**

**T**he foregoing information on estate planning for freehold mineral interests is not meant to be exhaustive. There are many additional factors which should be examined in structuring an estate plan involving your freehold minerals. Issues such as the clawback of Old Age Security benefits, the application of GST and alternative minimum tax may all have an impact on your decisions.

The information provided should not be considered to be legal or accounting advice. Everyone's situation is different and the information provided should only be used in conjunction with the advice of legal and accounting professionals.

The Freehold Owners Association thanks Mr. Dale Somerville, CA, of Edmonton and Ms. Tracy Hanson of the Calgary Law Firm of Beaumont Church LLP for their assistance.

#### **Nest Issue:**

In the next issue of your newsletter, *FHOA* will address some of the more recent developments in oil and gas law which impact freehold owners.

On behalf of the board of directors

Else Pedersen  
President

Canada Post Publications Mail  
Agreement No. 40048377