



Reference Guide

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ESTATE FREEZES



The estate freeze is a strategy used by many Canadian business owners to help accomplish estate-planning, business succession and asset protection objectives.

This reference guide provides a general introduction to estate freezes, outlines the potential benefits and disadvantages associated with these transactions and reviews implementation and structuring considerations.

## Introduction

An estate freeze is a mechanism that permits you to lock-in, or freeze, the value of your business interests at their current value by exchanging them for property having a static value. Future growth can be maintained and also passed to others as a result, which can produce a variety of potential tax and non-tax benefits. You will generally only consider implementing an estate freeze once you have accumulated sufficient wealth to live in your chosen lifestyle for the remainder of your lifetime.

Corporations are often used to facilitate the property exchanges involved in estate freezes. For example, transferring growth assets to a corporation in exchange for preference shares having a fixed value (sometimes referred to as freeze shares) is an effective way of capping your exposure to future growth. Entitlement to future growth will then pass to holders of new shares (common shares) issued as part of the estate freeze, instead of to you.

You would determine who would benefit from post-freeze growth, by deciding who will receive new common shares. Your decision would usually be based on a number of factors, including the relative financial position of the persons involved and your objectives for implementing the freeze. For example, if you did not anticipate a need to access future growth, common shares could be issued exclusively to others (such as your spouse, children or other family members). Conversely, if you anticipated occasional future cash flow shortfalls, you might also arrange for some new common shares to be issued to you personally. This is sometimes referred to as a partial freeze. Many factors affect the ultimate structuring of post-freeze shareholdings, including whether or not income-splitting is an objective of the estate freeze, tax and family law considerations and other factors.

Common shares issued as part of an estate freeze generally have a nominal initial value because the corporation's entire value is reflected in the freeze shares. This can allow new individuals to become equity participants in a corporation at minimal cost, which is often a key objective of business owners planning to transfer their business to next-generation family members, or non-family members such as key employees.

## Benefits

The specific benefits that you will derive from implementing an estate freeze depend on a number of factors. Possible benefits include:

- minimizing income and probate taxes on death
- creating income splitting opportunities
- facilitating capital gains exemption planning
- facilitating business succession
- allowing control following retirement.

## MINIMIZING INCOME AND PROBATE TAXES ON DEATH

Unlike the United States, Canada does not levy death taxes, per se. Nevertheless, Canadians can face significant income tax consequences when they die, due to tax rules that deem individuals to dispose of their assets immediately before death.<sup>1</sup> These rules generally result in the recognition and taxation, on death, of capital gains that have accrued throughout your lifetime.<sup>2</sup>

Since these rules apply to untaxed growth in the value of private corporation shares, successful business owners require careful estate planning in order to avoid substantial taxation on death. Estate freeze transactions are often employed to help manage this potential tax liability.

As described estate freezes transfer future growth to others designated by you (referred to as freeze beneficiaries). This results in a transfer of the responsibility to pay tax on that growth to the freeze beneficiaries, creating a tax deferral. Instead of the tax liability being triggered on your death, it is delayed until the freeze beneficiaries die or otherwise dispose of the shares. In the classic estate freeze scenario where next generation family members are named as the freeze beneficiaries, tax can be deferred over a potentially significant period of time.

Deferring tax is valuable since it is generally better to pay taxes later rather than sooner, particularly where lower income tax rates are anticipated in the future. The deferral value of an estate freeze includes both minimizing your date-of-death tax liability and increasing the net wealth of your estate freeze beneficiaries.

Estate freezes can also limit exposure to probate fees, which are a provincial tax imposed when courts process wills. Probate fees are usually applied according to an estate's value: as the value

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<sup>1</sup> The dispositions are deemed to occur at fair market value except, most notably, where a deceased transfers his or her capital property to a spouse (or to a qualifying spousal trust). In these situations the deemed disposition at fair market value will not apply and tax is deferred until the death of the surviving spouse (or until the spouse or spousal trust otherwise disposes of the property).

<sup>2</sup> This date-of-death tax liability can be mitigated where property qualifies for the capital gains exemption.

of an estate increases, so do applicable probate fees. Implementing an estate freeze to fix the value of your corporate interests limits exposure to future probate fees in the same way that it minimizes exposure to income tax on death - by preventing future growth from accruing to you.

Note, more generally, that undertaking an estate freeze helps identify and quantify income taxes and probate fees that will likely arise on death. Once determined, you can plan how best to deal with these liabilities within an overall estate plan, which might involve systematically redeeming your freeze shares or implementing life insurance strategies, alternative will arrangements and other solutions.

## **CREATING INCOME SPLITTING OPPORTUNITIES**

Splitting income by using family members' lowest marginal brackets to the fullest extent possible can reduce tax applicable to a family unit and can serve as a method of transferring wealth to the next generation. Facilitating income splitting is often a primary motivation for implementing an estate freeze.

Income splitting can be facilitated where, as part of an estate freeze, new shares are issued to other family members directly or indirectly through a family trust. Dividends could then be declared on the shares held by one or more freeze beneficiaries to the possible exclusion of others (as determined by you as director), effectively splitting the income that you would have otherwise received and been taxed upon. If the other family members are in a lower tax bracket, this could save income tax.

Children and other family members could be beneficiaries of a trust to which new common shares are issued (subject to the attribution rules discussed below). The appropriateness of using a trust depends on your circumstances. A trust could be appropriate where you:

- wish to maintain control over new growth shares
- have concerns about children's creditors or potential marital or family property claims
- wish to defer the decision as to which children or other family members will receive growth shares and in what proportions
- are uncomfortable with children or other family members being involved in current business affairs.

## **ATTRIBUTION RULES**

The purpose of the attribution rules in the Income Tax Act is to prevent spouses from splitting income and capital gains with each other and parents from splitting income with children. The rules can apply where you transfer property to a spouse or to a relative under the age of 18, or retain too much control over a family trust created as part of an estate freeze. If applicable,

income and/or capital gains from the assets are attributed back to you for tax purposes, preventing income splitting and the ability to minimize capital gains tax.

Corporate attribution is an attribution rule that must be considered when implementing estate freezes, since it can apply where property is transferred to a corporation for the benefit of a spouse or minor relative. If applicable, the rule deems you to receive an annual income inclusion, at a prescribed rate.

Corporate attribution can sometimes be avoided, most notably where your corporation satisfies the small business corporation (SBC) definition. This requires (among other things) that all or substantially all<sup>3</sup> of the corporation's assets are used in an active business in Canada. Corporate attribution could still apply if your corporation fell offside of the SBC definition at any time following an estate freeze.

Another way to avoid corporate attribution, if using a family trust, is to ensure that the trust restricts your spouse and any related person, niece or nephew under the age of 18 from being entitled to receive any trust income or capital during your lifetime.

Complex considerations are involved when structuring an estate freeze to avoid the attribution rules, for which professional advice is required.

Note that it is generally no longer possible to split income through dividend payments to minor children, grandchildren, nieces or nephews, due to the income splitting tax (often called the kiddie tax). This rule taxes private corporation dividends received by a minor child at the highest marginal rate, eliminating any income-splitting benefit. However, such income splitting is still possible with adult relatives.

## **FACILITATING CAPITAL GAINS EXEMPTION PLANNING**

The capital gains exemption can be used to shelter from tax up to approximately \$824,000 of capital gains arising from the sale (or deemed sale on death) of qualifying small business corporation (QSBC) shares.<sup>4</sup> Using the capital gains exemption is a key estate-planning objective for business owners and estate freezes are often used as a component of such planning.

For example, implementing an estate freeze can allow you to access the separate QSBC share exemptions of other family members. This can result in significant planning opportunities if, in the future, you are contemplating selling qualifying shares for proceeds that will exceed your personal capital gains exemption limit.

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<sup>3</sup> The Canada Revenue Agency (CRA) interprets this to mean 90%, although the Courts have held that in certain situations it may be less. Please see our reference guide on tax planning for the sale of your business for a detailed discussion of the SBC definition.

<sup>4</sup> To meet the QSBC definition, shares must satisfy various tests, including regarding the proportion of the corporation's assets that are active business-use assets versus passive non-business use assets. Details are further discussed in our reference guide on tax planning for the sale of your business.

Depending on your circumstances, you might also consider crystallizing your QSBC share exemption as part of an estate freeze transaction, if you suspect that the exemption will be repealed in the future or if your shares currently qualify as QSBC shares but you are concerned that they will not, going forward. If properly implemented, a crystallization transaction steps-up the cost base of your shares (to the extent elected) on a tax-free basis.

Strict technical requirements must be met in order for the QSBC share exemption to apply. Unanticipated negative tax consequences can arise if careful planning is not undertaken, particularly in non-arm's length share sale transactions. If, in the future, you are considering claiming the exemption in connection with your private corporation shares, you should consult with your professional advisors well in advance to ensure that all technical requirements are satisfied.

## **FACILITATING BUSINESS SUCCESSION**

As retirement approaches, owners start planning for business succession. In some cases, children will step in to carry on the business, while in others they will not. Alternatively, some children, but not all, will become involved.

Estate freezes are often used to facilitate transfers of business operations to the next generation. For example, if you wish to limit the financial barriers that your child or children might face to enter the family business, an estate freeze might be appropriate as it could facilitate new family members becoming equity participants at nominal subscription prices. Incorporating trusts into an estate freeze can permit succession objectives to be met as they develop over time and provide maximum flexibility to business succession planning, due to their inherent flexibility.

## **ALLOWING CONTROL FOLLOWING RETIREMENT**

Many business owners reach a stage where they are ready to step away from actively running their business but are averse to relinquishing control, due to emotional and financial ties. For some, maintaining control offers peace of mind where questions exist as to the business acumen of family members taking over the business. Estate freezes can be structured to allow you to back away from daily business operations while retaining a desired level of control.

One method of doing so is to issue control shares (voting preferred shares) to yourself as part of an estate freeze. This will not impair the objective of passing future growth entitlement to freeze beneficiaries, yet it satisfies the objective of not foregoing ultimate control over your business operations. Control shares are typically issued for nominal value. It is generally recommended that they form a different class of shares than the freeze shares, which separates your voting rights and equity value, creating added flexibility for future planning.

Implementing an estate freeze does not preclude you from continuing as a director and/or officer of a corporation, which can serve as another method of maintaining a voice in the direction and/or management of the business following retirement from active duty.

## Disadvantages

Some potential disadvantages must also be considered when determining whether an estate freeze is appropriate for you.

For example, professional costs will be incurred, both at implementation time and annually to meet tax-reporting obligations. The fees will generally vary depending on the complexity of your business affairs and current organizational structure. Prior to proceeding, your professional advisors should provide you with an outline of the costs that you can reasonably expect to incur.

There is also a frequent concern that implementing an estate freeze poses a risk to your future financial sufficiency. Careful planning is necessary to protect against undertaking a freeze transaction too early, before you reach a sufficient level of wealth. As well, consideration should be given to the range of pre-implementation strategies that can facilitate a freeze being reversed in the future, if necessary (see the related discussion below entitled “can I reverse an estate freeze?”).

Loss of control over business operations is also a common objection to proceeding with an estate freeze. As earlier described, some options exist to mitigate the amount of control that you will forego by freezing your business interests, which can help alleviate this concern.

## Implementation

### WHEN SHOULD I CONSIDER IMPLEMENTING AN ESTATE FREEZE?

Determining when to implement an estate freeze requires consideration of your financial position as well as your estate-planning and business succession objectives.

For example, if you own a start-up business that is just gaining momentum, you are unlikely to implement an estate freeze strictly for the purpose of divesting yourself of anticipated future growth, as it is improbable that you are in a financial position or stage of life to do so. Rather, you would use an estate freeze to cap your business interests once you have reached a comfortable level of personal wealth and, perhaps, a certain age.

However, a reorganization and partial estate freeze might still be warranted in your circumstances for the income-splitting benefits that it could provide. The decision would depend on your profit projections and family situation, together with the relative income levels of your family members and other considerations.

Market forces and valuation considerations can also affect the determination of when to implement an estate freeze. For example, if you are considering an estate freeze you should be aware of short-term business cycle forecasts and projections. If your objective is to minimize income and probate taxes, timing an estate freeze to occur when your business' value is depressed could result in additional growth being passed along to the beneficiaries of the freeze, further minimizing your exposure to taxes on death.

## CAN I REVERSE AN ESTATE FREEZE?

Business owners sometimes wish to reverse an estate freeze that has already been implemented, including when:

- unanticipated cash flow constraints arise in retirement
- conflicts develop with freeze beneficiaries
- other unanticipated post-freeze changes in family or financial situations occur
- misunderstandings exist as to the legal nature of the estate freeze (i.e. that the right to future growth was legally transferred to the freeze beneficiaries)
- the value of the corporation has decreased and the value of the freeze shares is no longer reflected in the corporation's current fair market value, which on death could have significant tax implications.

Implementing an estate freeze should generally be considered permanent and, as a result, should only proceed following careful consideration. That being said, there are certain planning measures that can help alleviate unanticipated future difficulties and which may allow for an estate freeze structure to be reversed or thawed, if proper advance planning is undertaken.

For example, if you anticipate sporadic future cash flow difficulties when planning an estate freeze, you should consider making advance arrangements for salary or bonus continuation following the freeze. Any such salary or bonus would have to be reasonable, in light of services you provide in the future, and must be considered in light of all other planning steps being undertaken (such as paying you a retiring allowance on your retirement, for example, which would be inconsistent with a decision to pay you an ongoing salary).

You should also canvass with freeze beneficiaries the corporation's post-freeze dividend policy, as dividends paid to you on your freeze shares will assist you with retirement cash flow needs. Maintaining a position as a director can help to ensure that you have a level of control over the payment of dividends, as can arranging for nominal-value voting control shares to be issued to you as part of the freeze transaction, as described above.

A unanimous shareholders' agreement (USA) is a form of shareholders' agreement that is signed by all shareholders of a corporation and by the corporation itself. A USA, which is binding on the corporation, can override a corporation's articles by restricting certain powers typically exercised by directors and stipulating that they are instead to be exercised by the shareholders.

As a precautionary measure, you might consider entering into a USA with the freeze beneficiaries that includes a clause requiring another freeze to be undertaken if requested in the future by you. The USA would stipulate that the refreeze would be for your benefit. To protect you, this kind of agreement should be signed immediately prior to implementing an estate freeze,

in order to prevent shareholders from changing their views on the merits of entering into the agreement.

Other, more exotic structuring alternatives exist that can allow for pre-planned unfreezes, including the use of conversion rights and other complex corporate law arrangements. Your professional advisor should be consulted regarding these possibilities when exploring estate freeze structuring options.

## **WILL I TRIGGER TAX CONSEQUENCES WHEN IMPLEMENTING AN ESTATE FREEZE?**

The possibility of inadvertently triggering income tax consequences is a concern whenever property is transferred. Estate freezes typically involve transfers of property that has appreciated in value and this creates a risk that inherent capital gains could be subject to tax immediately upon implementation. However, estate freezes are routinely structured to comply with special rules, allowing owners who implement properly-structured estate freezes to avoid triggering immediate income tax consequences.

As described above, tax that would otherwise apply is not eliminated; instead, these transactions are permitted to take place on a tax-deferred basis, delaying the application of tax until a future point in time (such as the next disposition of the property, for example).

There are several different rules that can defer tax that would otherwise apply to estate freezes, allowing for some flexibility when structuring these transactions. Planning alternatives will depend on your current structure and should be reviewed with your professional advisors.

Note that the CRA has established administrative guidelines that, in their view, must also be satisfied in order for an estate freeze to be a tax-deferred transaction.

In particular, the CRA requires that freeze shares have the following rights and attributes:

- Freeze shares must be retractable. This means that they must be redeemable at the option of the shareholder.
- Freeze shares must have a priority right to receive assets when the corporation is dissolved or wound-up.
- Freeze shares must be transferable without restriction, except for those imposed under corporate law.
- Freeze shares must have sufficient voting rights to protect against changes to the rights and attributes listed above.
- The corporation must be restricted from paying dividends on other share classes that will impair the corporation's ability to redeem the freeze shares.

## Conclusion

An estate freeze may provide significant tax and non-tax benefits for you and your family members if, for example, you have achieved a sufficient level of wealth to live in your chosen lifestyle throughout the balance of your lifetime or if you can take advantage of opportunities to split income. However, the tax benefits that might be achieved must be considered together with the potential consequences to your business operations, your personal financial sufficiency and your estate planning and business succession objectives. The preceding discussion is intended to outline many of the points that you should canvass with your professional advisors when reviewing the possibility of an estate freeze.

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