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Estate Freeze

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This article discusses estate freezes and illustrates how, in the right circumstances, they can provide both tax and non-tax benefits.

Due to the complexity of the tax rules that apply to estate freezes, you should obtain professional advice from a qualified accountant or lawyer who specializes in estate freezes and estate planning before acting on any of the information in this article.

One of the most fundamental aspects of estate planning is the periodic analysis of whether a “freeze” can and should be implemented in regard to one or more of your properties. Likely your most important property, and your fastest growing asset, is your business. Family businesses account for over 50% of Canada’s gross domestic product and employment. However, one of the greatest risks to a family business is succession — the passing of the business from one generation to the next.

An estate freeze is a strategy that can facilitate the succession of your family business by fixing the value of your shares in the business as of a particular date and passing the future growth on to your spouse and children.

To make this article, which is quite extensive, easier to follow, we have divided it into the following sections:

A. What is an estate freeze?

B. What type of company is ideally suited for an estate freeze?

C. Some advantages of an estate freeze

D. Some disadvantages of an estate freeze

E. How do you implement an estate freeze?

F. Case study illustrating potential estate freeze tax savings

Glossary of some key terms

A) What is an estate freeze?

An estate freeze is the term commonly given to a transaction in which you lock in or "freeze" the value of appreciating assets by transferring the future growth of the assets to other taxpayers, usually family members. You implement an estate freeze by exchanging property that is likely to grow in value (e.g. common shares) for another type of property that has no growth potential (e.g. preferred shares). If there is no potential for the property to increase in value, it will usually be preferable not to implement a freeze.

Capital gains tax on property generally becomes payable when you dispose of the property or as a result of a deemed disposition upon your death. (The exception to this rule, subject to attribution rules, is property that is transferred at death or during your lifetime to your spouse on a tax-deferred rollover basis.) One of the primary objectives of an estate freeze is to transfer the capital gains tax liability related to the future growth of an asset to your children. This will allow you to plan for the tax that will ultimately be payable upon your death because the value of the frozen property and the accrued capital gain on that property are known and will not change.

Although there are many types of estates freezes, this article focuses on the planning considerations for freezes involving incorporated family business owners and individuals with a portfolio of investments in an investment holding company. It also focuses on estate freezes that are implemented in favour of your spouse and children. Keep in mind, however, that an estate freeze may also be implemented in favour of unrelated key employees of an operating company.

Before implementing an estate freeze, you should undertake a thorough analysis of its pros and cons. Do not presume that an estate freeze is always advantageous.

B) What type of company is ideally suited for an estate freeze?

A company that is ideally suited for an estate freeze has some or all of the following characteristics:

- The operating company has grown to a size where you would use up all of your capital gains exemption (CGE) on the disposition of the company. You have a spouse and/or children who have not yet utilized their CGEs; and the operating company is expected to grow significantly in the future.
- You have sufficient assets to enjoy a comfortable retirement, even after taking the effects of inflation into consideration.
- One or more of your adult children are not in the top marginal tax bracket.
- You have been providing financial assistance to one or more of your adult children who are not in the top marginal income tax bracket (e.g. a child in university).

- You have an operating company and one or more of your children have expressed a strong interest in continuing to operate the family business after you die.
- You have sufficient assets to enjoy a comfortable retirement, and you reside in a jurisdiction with high probate tax (e.g. Ontario or British Columbia).
- You have sufficient assets to enjoy a comfortable retirement and you have children from a previous marriage to whom you want to give significant gifts prior to death.
- You have an operating company, and the exposure to lawsuits in the operation of your business has caused you to consider gifting surplus funds to your children for creditor protection reasons (assuming you have sufficient assets to enjoy a comfortable retirement).
- Some advantages of an estate freeze

C) Some advantages of an estate freeze

TAX DEFERRAL

A central purpose of an estate freeze is to defer the capital gains tax on property that you will eventually transfer to your children, usually at the time of your death. The value of the property held by your children after the freeze will not be subject to tax at the time of your death. The overall tax will not be eliminated, but there will be a deferral of tax from the time your children receive the property until they dispose of it.

If the assets to be frozen (e.g. the shares of the company) are likely to be sold soon after your death, implementing an estate freeze may not be the best solution (at least not if tax deferral is the main purpose of the freeze) since your children will most likely have to pay tax on the sale of the assets in any event.

INCOME SPLITTING

The primary advantage of income splitting is the ability to divert dividends from your company to your spouse and children, who are presumably in relatively low marginal income tax brackets. Depending on your province of residence and whether your spouse and children have other sources of income, you could provide each family member with approximately $30,000 to $50,000 worth of tax-free dividends.

This benefit is much more significant than the income splitting benefit derived from paying family members a salary for the work they do in the business. This is largely because salaries paid to family members are taxable in their hands and are required to be “reasonable”, which means their salary must be a fair reflection of the amount of work they do for the business. With the introduction of the “kiddie tax” in 2000, only low-income earning adult children will likely benefit from this income splitting strategy. The kiddie tax was designed to discourage income splitting with minors by taxing dividends paid to minors by a private corporation at the highest marginal tax rates.

It should be noted that dividends derived inside a family trust from public corporations are not subject to the kiddie tax. In this case, there are still opportunities to split investment income with minor children. If, in implementing an estate freeze, you wish to split investment income with minor children, you must use a trust. However, you should keep in mind the attribution rules that may apply in certain circumstances.

Income splitting may be achieved with a discretionary trust provided the income is actually paid to the minor child or the amount is payable when the child turns 18 years old through the use of a promissory note. However, this condition is problematic given that some parents may not want to give control over large amounts of money to an 18-year-old child. Therefore, pursuant to subsection 104(18) of the Income Tax Act, such parents may consider establishing a non-discretionary income-splitting trust whereby any income earned in the trust before the year the beneficiary turns 21 is deemed to have become payable but the beneficiary cannot enforce payment of that amount until age 40.

MULTIPLYING $750,000 CGE AMONG SEVERAL FAMILY MEMBERS

The Income Tax Act grants a significant tax break on capital gains incurred on the sale of private company shares. This is usually referred to as the lifetime Capital Gains Exemption (CGE) and is available to owners of shares of qualifying small business corporations (QSBCs).

In order to qualify for this exemption, your business must not be a public company and must be controlled by Canadians. Also, at the time the shares are sold or disposed of, 90% of the fair market value of the company's assets must be used in active business in Canada. If an operating company does not meet this test, often surplus funds will be transferred to a related holding/sister company on a tax-free basis. This is called "purifying" the operating company.

In order for a business to be viewed as capital property (rather than inventory), the taxpayer (or related person or partnership) must have owned the shares in the 24 months immediately preceding the sale. Further, throughout this 24-month period, at least 50% of the fair market value of the company's assets must have been used in active business in Canada. And finally, the business must not be one of these:

- A personal service business (i.e. an incorporated employee as opposed to an independent consultant) unless it employs a minimum of six people on a full-time basis
- A specified investment business (i.e. a business whose principal purpose is to derive income from property) unless it employs a minimum of six people on a full-time basis

Agricultural property owned by farmers, anglers and other agricultural producers is eligible for the CGE. As well, agricultural businesses need not be incorporated to benefit from the CGE.

Basically, the first $750,000 of the capital gain on the disposition or sale of such shares can be earned tax-free. Each Canadian taxpayer is entitled to one lifetime $750,000 CGE that may be used up on a single sale or over multiple sales. Depending on your province of residence, each fully utilized CGE will equate to tax savings of $146,250 to $182,250.

In making a decision to freeze, consider both the present capital gain and future capital gains. If the total estimated gain is below $750,000, there is no need to freeze (at least not if multiplying CGE is one of the main purposes of the freeze). However, if the growth of the business is substantial, or is expected to be substantial in the future, it may be worthwhile to implement an estate freeze in favour of children as a means of ensuring that each family member utilizes their lifetime CGE, thereby reducing the capital gains tax that would otherwise arise on the disposition of the shares of the operating company.

CREDITOR PROTECTION

An estate freeze will limit your interest in your operating company and thereby reduce your exposure to creditors.

Also, judicious use of a holding company can provide creditor protection for an operating company by moving excess cash from the operating company to the holding company. However, it is recommended that if the holding company is incorporated, you (or a family trust) should directly own some of the shares of both the operating company and the holding company, rather than the holding company owning all of the shares of the operating company, to ensure that the shares of the operating company that qualify for the CGE can be sold to a third party without requiring another corporate reorganization.

PROBATE FEE REDUCTION

Although probate fees are not a significant issue in some provinces in Canada (e.g. Quebec and Alberta), an estate freeze will effectively reduce the size of your estate at death, and will therefore directly reduce probate fees that would otherwise arise at death. However, if probate fee reduction is your sole objective and you are at least 65 years of age, an alter ego trust or a joint partner trust may be a more cost-efficient way to reduce your exposure to probate fees. Alternatively, a multiple Will strategy may be used to reduce probate fees.

MARITAL CONSIDERATIONS

An estate freeze can be helpful in developing a preferred estate distribution scheme at death. For example, if you are in a second marriage, implementing an estate freeze prior to death in favour of your children from a prior marriage may be an effective way to reduce the size of your estate. And such a reduction in the size of your estate at death may be helpful in light of the requirement (under provincial dependant relief legislation) to provide an adequate inheritance for your (financially dependent) second spouse.

INTER-PROVINCIAL TAX PLANNING

Alberta has one of the lowest personal tax rate structures in Canada, and as such, has come to be known as a domestic “tax haven” for its residents. However, there are still opportunities for individuals who reside in other provinces to take advantage of the lower Alberta tax rates. The key to an inter-provincial tax plan is having a taxpayer resident in Alberta. Therefore, to the extent that your estate freeze utilizes a trust, some thought should be given to Alberta as a possible jurisdiction for the trust. Generally, the residence of a trust is dependent upon the residence of the trustees who exercise management and control of the trust’s assets.

D) Some disadvantages of an estate freeze

The following are various disadvantages or costs of an estate freeze, many of which are relatively subtle:

LEGAL AND ACCOUNTING COSTS

You will incur legal and accounting fees to implement an estate freeze. The cost of an estate freeze currently ranges in price, from $3,000 and up, depending on the complexity of the freeze. There will likely be ongoing accounting fees related to either more numerous or more complicated annual income tax filings. And, as your corporate affairs become more complicated, it is likely you will need to rely, to an even greater extent, on the advice of your accountant and tax lawyer. However, accounting and legal costs usually pale in comparison to the many benefits that can be derived from an estate freeze.

INFLATION

Over time, inflation will reduce the real value of your frozen preferred shares and may compromise your ability to enjoy a comfortable retirement. It is important to ensure that the effects of inflation do not leave you without sufficient income-producing assets to meet your personal needs.

If your operating company isn't large enough, it may be too soon to effect an estate freeze. In this case, you may choose to effect a partial estate freeze, where the new common shares are issued to both you and your family members, to ensure that you continue to participate in some of the growth of the company.

CONTROL

As part of the overall estate plan, you may wish to retain some control over the frozen assets. Ordinarily, you will maintain control by virtue of holding preferred shares with voting rights.

Also, it is not uncommon for the new common shares to be issued to a family trust and for your spouse and children to be the beneficiaries of such a trust. Family trusts are ordinarily collapsed prior to their 21st anniversary because there is a deemed disposition of trust assets on the 21st anniversary of the trust that will otherwise trigger any accrued capital gains. If the trust property is distributed to the beneficiaries prior to the 21st year deemed disposition, the distribution can be done on a rollover basis. Therefore, you might enjoy the flexibility afforded by effecting an estate freeze with the use of a trust; it will give you 21 years to decide which percentage of ownership to allocate to each family member, and often the percentage eventually allocated to a particular child will reflect the extent to which that child has contributed to the growth of the company. Also, the use of a trust may have some creditor-protection benefits, and it will facilitate significant tax savings as a result of the ability to allocate income from the trust on a discretionary basis to your spouse and children, who are presumably in lower marginal tax brackets.

INCOME ATTRIBUTION

It is important to ensure that the tax lawyer who structures and implements the estate freeze is cognizant of the multitude of technical tax rules in this area. If the estate freeze is not carried out properly, the income attribution rules in the Income Tax Act may require you rather than your spouse or child to report the income for tax purposes. This will result in the complete failure of one of the main purposes of the freeze, namely income splitting.

Also, particular caution should be exercised in circumstances where property is transferred or loaned to your spouse or to a related minor child, either directly or indirectly, through a trust. In regard to a minor child, income, but not capital gains, will be attributable back to you.

Particular caution needs to be taken in estate freezes involving trusts. In order to avoid the attribution rule, the trust used in the estate freeze should be irrevocable. Also, you, as the person who transfers property to the trust, should not be seen to exert any control over the trust. For example, you should not be named as sole trustee or retain any power to name future new beneficiaries of the trust.

CORPORATE ATTRIBUTION

Corporate attribution must also be considered. If you transfer or loan property to a company for the benefit of a spouse or minor child, the amount of the property is deemed to be a loan and it will be deemed that you have received interest at the prescribed rate on that loan. This attribution rule does not apply to corporations with 90% or more of its assets in an active business, but it is a concern if it holds investment assets. Corporate attribution is also eliminated if you receive interest from the corporation equal to the deemed interest. Therefore it can be avoided, but it needs to be carefully considered.

DEEMED TAXABLE BENEFIT REGARDING PERSONAL USE PROPERTY

A personal use property such as a family cottage should not be held in a holding company because it will likely be deemed as a taxable benefit to the shareholder.

IMPROPER VALUATION MAY RESULT IN DEEMED TAXABLE INCOME

A proper valuation of the assets being frozen is critical to a successful estate freeze. If the valuation is too low vis-à-vis fair market value, a full rollover will not be achieved and some capital gains tax will likely be triggered. Alternatively, if the valuation is too high, you may be deemed to have received taxable income. Therefore, as a precaution against valuation difficulties, the transfer documents (in regard to property being transferred to a holding company) should contain a price adjustment clause.

Table summarizing main advantages and disadvantages of estate freezes

	Operating company	**Holding company alone**
Advantages	Tax deferral	
	Income splitting (children/spouse/key employees)	Income splitting (children/spouse)
	Multiplying CGEs	
	Creditor protection	
Disadvantages	Legal/accounting costs	Legal/accounting costs
	Inflation	Inflation
	Control	Control
	Income attribution	Income attribution
		Corporate attribution

E) Different methods of implementing an estate freeze

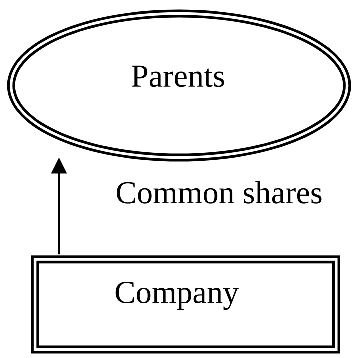
HOW A SIMPLE ESTATE FREEZE IS IMPLEMENTED

An estate freeze can be as simple as selling or gifting property to your child. However, such a transfer or gift will ordinarily trigger an immediate tax liability for you. An estate freeze can be done without an immediate tax liability if it is done through a corporation.

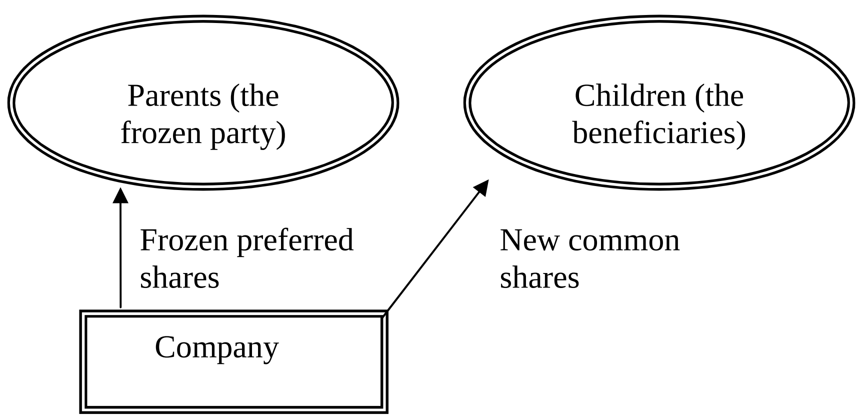
When you transfer property, such as ordinary common shares, to a company in return for fixed redemption-price preferred shares, the value of that property (the common shares) is effectively frozen into those preferred shares. New common shares with nominal or negligible value are issued in favour of your children. Corporate estate freezes like these can be effected without triggering any immediate tax liability because the transfers to the corporation can be done on a rollover basis.

The following diagrams illustrate a simple pre- and post-corporate estate freeze.

Pre-estate freeze



Post-estate freeze

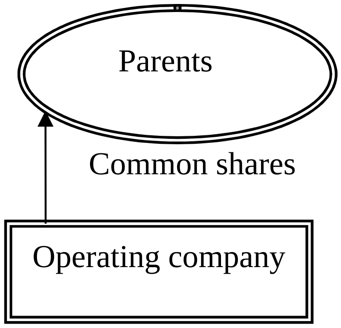


STRUCTURING A FLEXIBLE AND TAX-EFFICIENT ESTATE FREEZE

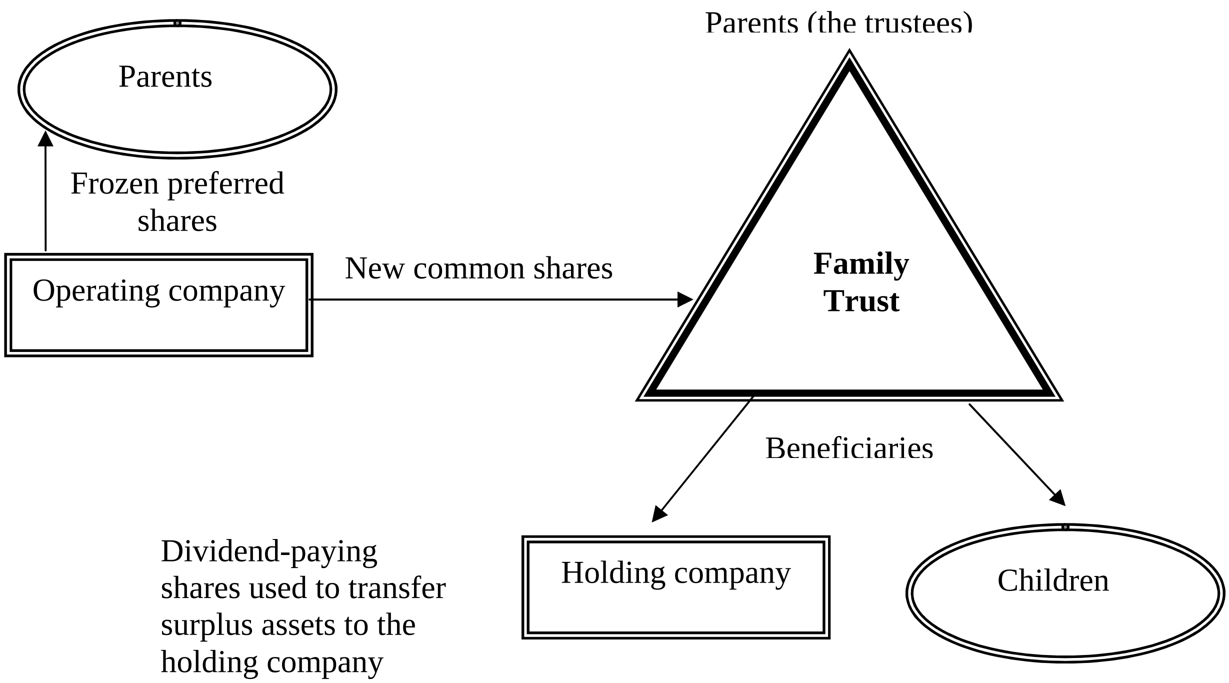
There are a number of variations of estate freezes that are possible. A detailed examination of the pros and cons related to each type of estate freeze is beyond the scope of this article. The following objectives should be sought when working with your qualified tax advisor to structure a tax-effective estate freeze:

- The Income Tax Act is silent in regard to estate freezes; however, the Canada Revenue Agency has stated that the frozen preferred shares issued in an estate freeze must be fully retractable and fully redeemable.
- When implementing an estate freeze for an operating company, you must ensure that 90% of its assets are used in the business at the time of sale in order to qualify for the CGE. Therefore, consider transferring excess assets (such as cash and marketable securities) to a holding/sister company. This process is generally referred to as "purifying the operating company". In addition to permitting the parents/owners to each qualify for and crystalize their $750,000 CGE, such a transfer may be helpful from a creditor-protection perspective. In other words, if the operating company is successfully sued, it may be helpful if surplus assets were transferred to a separate corporation prior to the commencement of the lawsuit.
- In most estate freezes, it will be helpful to have a family trust subscribe for new common shares. The advantage of utilizing a family trust, instead of issuing new common shares directly to your children, is that it provides more flexibility. You can be one of the trustees of the family trust, and thereby, keep control of the trust assets. Furthermore (assuming that you wish to avoid the deemed disposition of trust assets at fair market value on the 21st anniversary of the trust) you have 21 years to decide how to divide the percentage ownership of the new common shares among your children. For example, if you have an operating company and one of your children has contributed to the growth of the business more significantly than your other children, you may choose to eventually provide this child with a relatively larger percentage of ownership. Also, the trust may provide some creditor protection relief in a matrimonial property claim in the event that one of your children divorces.
- It is best to keep U.S. citizens and U.S. residents out of an estate freeze in order to avoid adverse tax consequences caused by the U.S. gift tax and U.S. grantor trust rules. For example, if one of your children resides in the U.S., you may wish to make alternative attempts to provide them with compensation rather than naming them as a beneficiary in an estate freeze.

Pre-estate freeze



Post-estate freeze



F) Case study illustrating potential estate freeze tax savings

A 50-year-old widowed business owner (the taxpayer) resides in Ontario (where the top personal marginal tax rate is 46.4%) with triplets, all of whom are adults enrolled as first-year students in university. The business is a pharmacy. Also, the taxpayer suspects that none of his children will earn a significant amount of income for the next 10 years because each of them intends to remain in university for approximately a decade.

At present, the taxpayer owns an operating company worth $3 million. In 10 years, the taxpayer suspects his operating company will be worth approximately $9 million, at which time he will likely sell all the shares of the operating company to a third party. For the sake of this example, assume that on an annual basis throughout the next 10-year period, the business earns an annual surplus of approximately $616,000 wherein the pharmacist pays himself a $216,000 bonus, which in turn results in an annual taxable income for the operating company of approximately $400,000.

Also, the taxpayer wishes to provide each of his children with a $32,000 tuition and living allowance on an annual basis for the next 10 years. Therefore, the taxpayer will require a mere $19,776 per annum for himself after taxes are paid on his bonus and after his three kids receive a collective allowance of $96,000 per annum. To keep the tax calculations relatively simple in this example, let's assume that i) there is negligible growth on any passive investment income in the company; and ii) the taxpayer has exhausted his personal marginal tax rates through earning a large amount of income from a $3 million investment portfolio.

The following table compares the amount of tax the taxpayer would incur over the next 10 years (including tax from the sale of operating company shares at the end of the 10-year period) without an estate freeze versus the amount of tax he would incur with an estate freeze.

	Without estate freeze	**With estate freeze**
Annual surplus earned by the business	$616,000	$616,000
Annual bonus paid to the taxpayer	$216,000 ($19,776 after tax and allowances are paid)	$36,896 ($19,776 after tax)
Annual collective tax-free dividends paid to the triplets	0	$96,000
Annual taxable income of the operating company	$400,000	$579,104
Annual corporate tax paid	$66,000 ($400,000 x 16.5%)	$126,000 ($66,000 + [$179,104 x 33.5%])
Annual tax paid on bonus	$100,224	$17,120
Proceeds from the sale of the business	$9,000,000	$9,231,040[1]
Taxable capital gain (after deducting CGE)	$4,125,000	$3,115,520
Tax on the disposition of the operating company's shares (a)	$1,914,000	$1,445,601
Total corporate tax (b)	$660,000 ($66,000 x 10 years)	$1,260,000 ($126,000 x 10 years)
Total tax paid on bonus (c)	$1,002,240 ($100,224 x 10 years)	$171,200 ($17,120 x 10 years)
Total tax (a) + (b) + (c)	$3,576,240	$2,876,801

In this example, the numerical tax benefits of the estate freeze are as follows:

- Approximately $700,000 net overall tax savings (which occur due to $96,000 worth of annual tax-free dividends distributed to the adult children as well as the extra three CGEs resulting in approximately $522,000 worth of tax savings)
- Approximately $23,104 annual net tax deferral

[1] Each year the net tax-effectiveness of distributing tax-free dividends will cause the corporation's retained earnings to be approximately $231,040 greater than it would be over a 10-year period.

Glossary of some key terms

When you speak with your tax advisor about estate freezes, they may use some technical words. The following are some brief descriptions of some common estate-freeze concepts:

MELT

A "melt" is a transaction whereby part of the appreciation of the company is diverted back to you without any modification to the corporate structure. An example of a melt is a gradual redemption of the frozen preferred shares over time. Therefore, to the extent that an estate freeze freezes your tax liability, a melt that is added onto an estate freeze actually results in a gradual and eventual reduction of tax that would otherwise be payable upon your death. Tax advisors often recommend that their clients give serious consideration to implementing tax-minimization melt strategies in addition to any estate freeze.

THAW

A "thaw" refers to the process of unwinding an estate freeze. The corporation could either re-acquire the growth shares, or the growth shares could be transferred back to you. In either event, your children will likely have to pay capital gains tax, unless the taxable gain is covered by the child's lifetime $750,000 CGE.

GEL

A "gel" is the most common type of "thaw". A common method of effecting a gel is for you to be included as a discretionary beneficiary of the family trust. It is recommended that caution be exercised in structuring such transactions because if you have transferred shares to the family trust and you are also named beneficiary of such trust, attribution rules may apply. The effect of the attribution rules is all income and capital gains of the trust are attributed back to you, which, in turn, will negate any income splitting advantages that would have otherwise arisen.

REFREEZE

In some cases the overall value of a corporation decreases after a freeze. In such situations it will be beneficial to undertake a new estate freeze at a lower value.