The Navigator

Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Estate freeze

Freeze the value of your assets and transfer future growth to your family

If you are the sole owner of a corporation that has appreciated in value over time and is expected to continue growing, there are ways to structure the ownership of your corporation to improve tax efficiency and simplify the planning for your estate. An estate freeze is a tool that can be used to restructure the ownership of your corporation by capping the value of your assets and transferring future growth to the next generation of owners. This article focuses on planning considerations for freezes involving incorporated family businesses and individuals with a portfolio of investments held in an investment holding company. Throughout the article, the presumed beneficiaries are family members but an estate freeze can also be used for transfers to key employees or other successors.

Any reference to a spouse in this article also refers to a common-law partner.

Please contact us for more information about the topics discussed in this article.

What is an estate freeze?

An estate freeze refers to a transaction where you lock-in or “freeze” the value of appreciating assets. The intent is to transfer the future growth of the assets and their associated tax liability to other taxpayers, usually family members. An estate freeze is implemented by exchanging property that is likely to grow in value (e.g. common shares of your business) for property with no growth potential (e.g. fixed-value preferred shares of your business). Estate freezes generally makes sense only when there is an expectation that the corporation will grow in value, resulting in capital gains, and where there is a clear successor or next generation of owners.

Generally, when you dispose of property, including a deemed disposition on death, capital gains and associated taxes are triggered. A notable exception is when property is transferred to a spouse. If you intend to sell or gift property to someone other than your spouse, the potential capital gains tax could be substantial, especially if the property has greatly appreciated in value. By implementing an estate freeze, you may be able to limit your accrued capital gain on the property and transfer future capital gains to your intended beneficiaries without triggering immediate tax consequences. Aside from the deferral of capital gains tax, the other benefit of the strategy is that it allows you to plan for the tax that will be payable upon the eventual disposition of the property, including the deemed disposition on death. By capping your accrued capital gains

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on the transferred property, you and your professional advisors can estimate the tax liability and look at strategies for funding it.

When would you consider an estate freeze?

Before you consider an estate freeze, be sure that you do not require the future growth to fund your legacy and lifestyle needs. An estate freeze works best when you want to achieve one or more of the following objectives:

- You want to minimize and defer tax.
- You operate a business and have family members take over the business after you retire or after your death.
- You wish to income split with family members who are in a lower marginal income tax bracket than yourself.
- You own an operating company that has grown to a size where you would use all of your lifetime capital gains exemption (LCGE) on the disposition of the shares of the corporation. You may also have a spouse and/or children who have not used their LCGEs and you expect your business to grow significantly in the future.
- You reside in a jurisdiction with high probate fees (e.g. Ontario or British Columbia) and want to minimize such fees.

These objectives are discussed further in the sections below.

Tax minimization and deferral

A properly implemented estate freeze will allow you to defer the taxes payable on the accrued gain on the shares of your corporation and transfer the future growth of your business to your beneficiaries. Because the growth is passed on to your other family members, you limit the amount of tax you will pay on the sale or deemed disposition of the shares of your corporation. You are only responsible for the taxes payable on the frozen value of your shares. In addition, if your family members are in a lower income tax bracket, they will pay less tax than you would on the future growth. This will lower your family's overall tax bill.

Second, typically, you do not realize the accrued gain at the time you implement the freeze. The taxes are payable on the accrued gains at a future date, for example, when you sell or are deemed to have disposed of the shares. The future growth of the corporation is passed on to your family members. This future growth is not taxable to you if your shares are sold and is not deemed to be realized at the time of your death. Thus, you can defer the taxes payable on this future growth until your family members dispose of or are deemed to have disposed of their shares of the corporation.

If you intend to sell the shares of your corporation shortly after you freeze, or if your family members intend to sell the shares soon after your death, an estate freeze may not make the most sense for you and your family since the ability to defer taxation in these situations could be minimal. Be sure to talk to your family members and determine their goals before implementing an estate freeze.

Estate freeze as part of your business succession plan

As a business owner, your business may be your largest and most important asset. 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 one of the tools that can facilitate the succession of the ownership of your family business by fixing the value of your shares in the business as of a

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particular date and passing the future growth on to your family members.

Typically, you can use the frozen portion of the business to fund your retirement, while your family members who are successors to your business can begin to work in the business and contribute to the future growth of the business.

Income splitting

By implementing an estate freeze, you may be able to income split with your lower-income family members. The estate freeze allows you to introduce your lower-income family members as shareholders of your corporation without triggering tax. Your corporation can then pay dividends to your family members who are in lower marginal tax brackets thereby reducing your family's overall tax bill. If your spouse and children have little or no other sources of income, you may be able to provide each family member with dividends from your corporation that attract no income tax or very little tax.

That said, it is important to note that there are "tax on split income" (TOSI) rules which limit splitting certain types of income from a corporation with family members. As of January 2018, the TOSI rules became more restrictive – applying to adult family members as well as minors. The changes were designed to discourage business owners and professionals from income splitting with family members who do not meaningfully contribute to the business or practice.

The TOSI rules apply to many types of income received from a private corporation, including interest, dividends, as well as certain capital gains but they do not apply to salaries or bonuses. Where TOSI applies, the income received by the family member is subject to tax at the highest marginal rate, regardless of the individual's actual marginal tax rate. In addition, the individual loses the ability to claim personal tax credits on the split income, such as the basic personal tax credit.

The TOSI rules are complicated and you'll want to work with a trusted tax advisor to understand how they apply in your specific situation. For example, there are some exclusions to TOSI, which differ depending on the age of the individual receiving the income. The age categories include minors under age 18, adults age 18 to 24, and adults age 25 and over. There is also an exclusion available to the spouse of a business owner who is age 65 or older. The exclusions mainly rely on whether the family member is significantly involved in the business or owns a certain portion of the votes and value of the corporation's shares. The exclusions are generally more restrictive for minors and for professional corporations.

Multiplying the lifetime capital gains exemption

There is a significant tax break on the capital gains you realize on the disposition of certain private company shares. The LCGE is available to individuals who dispose of shares of a qualifying small business corporation (QSBC). The LCGE was increased effective for 2014 to $800,000 for dispositions of QSBC shares and is indexed for years after 2014 (you can find the current year LCGE on the Canada Revenue Agency (CRA) website). For more information regarding the types of shares that qualify as QSBC shares, please ask an RBC advisor for our article on the capital gains exemption on private shares.

In making a decision to freeze, consider both the present capital gain and future capital gain of the business. If the value of the business will increase beyond the amount of LCGE available to you, you may want to consider implementing an estate freeze to transfer some of the growth to your family members. Each

Depending on which province you reside in, you may be concerned with probate fees. Assuming your business continues to grow in value, an estate freeze will limit the size of your estate and therefore reduce probate fees payable.

individual shareholder is entitled to claim a LCGE during their lifetime on the disposition of qualifying property. Therefore, if your family members are also shareholders, they may be able to make use of their exemptions and reduce the total taxes payable on the sale of your business. Just note that there may be negative tax implications if the shareholders are minors (under the age of 18) and the shares of the corporation are sold to a non-arm's length party.

Probate fee reduction

Depending on which province you reside in, you may be concerned with probate fees. Assuming your business continues to grow in value, an estate freeze will limit the size of your estate and therefore reduce probate fees payable. Please note that there are other strategies that you can employ to reduce probate fees. For example, if you are 65 years of age or older, you may want to consider an alter ego or joint partner trust. Alternatively, in some provinces, you may be able to employ a multiple Wills strategy for your private company shares to reduce probate. Speak with a qualified legal and/or tax advisor to determine a suitable strategy to deal with the potential probate fees you may incur.

Common traps or concerns

Implementing an estate freeze can be very complex, therefore, it is important that you use a tax professional that is cognizant of the multitude of technical tax rules in this area and the possible pitfalls. It is important to weigh the costs and risks against the potential benefits of an estate freeze prior to implementation. The following are some of the things you should consider before implementing an estate freeze.

Legal and accounting costs

You will incur legal and accounting fees to implement an estate freeze. In addition, if you introduce a holding company and/or a family trust to your business structure as part of the estate freeze, you may increase the complexity and the ongoing legal and accounting fees you incur. You need to be aware of these fees and the increased complexity of your affairs prior to implementing an estate freeze.

Attribution

If an estate freeze is not properly structured, the attribution rules may apply. The attribution rules limit taxpayers from income splitting with certain parties. If attribution applies, income paid or made payable to your children or your spouse may be taxable in your hands instead. You should exercise caution when lending or transferring assets to or for the benefit of your spouse or to a non-arm's length minor, either directly or indirectly, through a corporation and/or a trust.

Particular caution needs to be taken in estate freezes involving trusts. To avoid attribution back to the settlor or a person that contributes to the trust, the trust used in the estate freeze should be irrevocable. It is important to pick the right settlor, trustee/s, capital and income beneficiaries and trust terms.

In addition, if you transfer or loan property to a corporation and one of the main purposes is to reduce your income and benefit a spouse or a non-arm's length minor, then the corporate attribution rules may apply. The most common way of doing an estate freeze is viewed by the CRA as a transfer of property to a corporation and one of the main purposes of

If you are incorporating a trust in the estate freeze, you should be aware of the 21-year deemed disposition rules for trusts. In order to prevent the indefinite deferral of capital gains accumulated in a trust, the trust is deemed to have disposed of its assets every 21-years for tax purposes.

an estate freeze is to reduce your income and benefit your spouse and/or children. If the corporate attribution rules apply, you may have to include an annual interest amount on your income tax return. The interest amount is calculated as the value of the property you loaned or transferred to the corporation multiplied by the CRA prescribed interest rate. This interest amount is included in your income even if no income from your corporation is paid to your spouse or a non-arm's length minor. That said, there are ways to manage corporate attribution. For example, you can reduce the benefit amount by receiving interest or taxable dividends from the corporation.

Corporate attribution does not apply to a Canadian-controlled private corporation if all or substantially all (generally means 90% or more) of the fair market value of its assets are used in an active business carried on primarily in Canada. Therefore, corporate attribution is a concern only if your corporation holds passive investment assets exceeding 10% of the fair market value of its total assets.

Inflation

Over time, inflation may 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 with insufficient funds to meet your personal needs.

If the value of your corporation isn't large enough yet, it may be too soon to implement an estate freeze. In this case, you may choose to implement a partial estate freeze where you issue new growth common shares to both you and your family members, possibly through a family trust, to provide more flexibility. This allows you to continue to participate in some of the future growth of the corporation, if necessary, and reduce the effects of inflation on your wealth.

Trusts and the 21-year deemed disposition rules

If you are incorporating a trust in the estate freeze, you should be aware of the 21-year deemed disposition rules for trusts. In order to prevent the indefinite deferral of capital gains accumulated in a trust, the trust is deemed to have disposed of its assets every 21-years for tax purposes. This means that the trust must report all accumulated gains and losses on its tax return as if it actually sold the assets for fair market value. If the trust holds real estate or business assets, you may need to engage valuators to establish a proper value. Any gains realized as a result of this deemed disposition are taxed in the trust at the highest marginal tax rate in the trust's province of residence. These gains cannot be allocated to a beneficiary to be taxed in their hands.

Even though the trust is deemed to dispose of all assets and pay the tax on the resulting capital gain, it does not mean the trust must be wound-up. Once the tax is paid, the trust continues to operate as it did before.

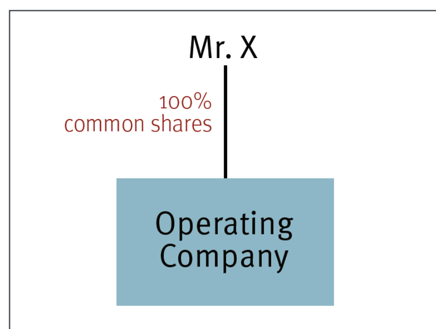
If you are utilizing a trust in the estate freeze, you'll want to consider the timing of when you freeze. If you expect the freeze to be in place for longer than 21 years, consider taking steps to plan for the deemed disposition. Speak to a qualified tax and/or legal advisor regarding the planning that may be available.

If you are planning to use a holding company but you want to maintain the ability to claim the LCGE on the sale of your operating company, careful planning should be considered.

Examples of estate freeze structures

There are various methods of implementing an estate freeze and different possible structures. However, a detailed examination of each is beyond the scope of this article. The following discussion highlights one of the common methods of implementing an estate freeze and illustrates some of the common post-estate freeze structures.

Here is a diagram of what an existing structure may look like before implementing an estate freeze:



Mr. X may freeze the value of his common shares by transferring them to his operating company in exchange for frozen preferred shares equal in value to the existing value of his common shares. When you transfer property, such as ordinary common shares, to a corporation in return for fixed value, redeemable, retractable preferred shares, the value of the property you transfer is effectively frozen in the new preferred shares you receive in return. Since all of the value of your corporation is now in the preferred shares, new common shares with nominal value can then be issued to your spouse and/or children. Estate freezes like these can be implemented without triggering any immediate tax liability because the transfer to the corporation can be done on a rollover basis under various income tax rules.

You may decide to introduce a holding company as part of your estate freeze. Having a holding company as part of your structure may allow you to move passive assets from your operating company to your holding company on a tax-deferred basis. This may allow you to achieve two things: it may allow you to keep your operating company purified for LCGE purposes as the passive assets are removed; and it may provide your operating company with some creditor protection as the value of the operating company is reduced. In the past, this was fairly easy to achieve by paying tax-free inter-corporate dividends from your operating company to your holding company. However, recent changes to the income tax rules related to inter-corporate dividends have made this more difficult.

If you are planning to use a holding company but you want to maintain the ability to claim the LCGE on the sale of your operating company, careful planning should be considered. Keep in mind that only individuals can claim the LCGE so if your holding company sells the shares of your operating company, it will not be able to claim the LCGE. In a case like this, you may want to consider continuing to hold some of the operating company shares personally or have your family members own the operating company shares, directly or indirectly through a trust, to ensure the LCGE can be accessed if you sell the shares of your operating company.

In addition, the federal government recently introduced rules that restrict access to the small business deduction for Canadian controlled private corporations that have significant income from passive investments in their corporation, or associated corporations. A holding company and an operating company could be associated which would mean that the amount of passive investment income in the holding company could affect the small business deduction for the operating company.

You may decide to use a family trust when implementing your estate freeze. This may allow you to retain some control of the common shares by being one of the trustees of the trust. It may also provide flexibility in determining who gets the income from the common shares and who will ultimately receive the common shares held by the family trust.

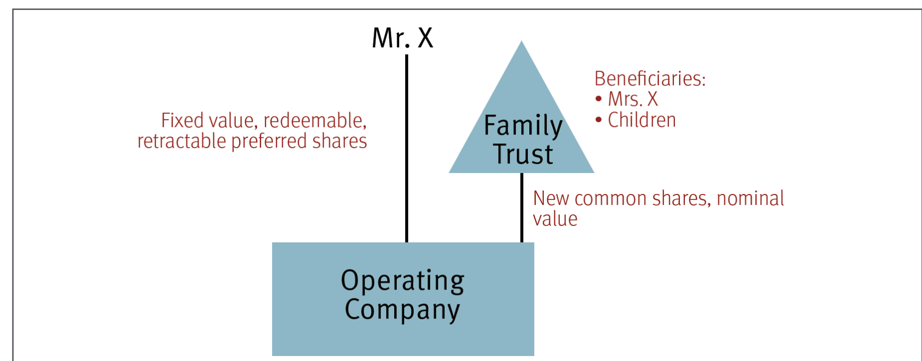
For all these reasons, if your corporation is considering introducing a holding company as part of the estate freeze, you should involve a qualified tax professional. The tax professional will need to ensure that tax-free inter-corporate dividends will not be re-characterized into capital gains, which are taxable. They can help you assess whether the post-estate freeze structure allows you and your family to claim the LCGE, should you plan on selling the business in the future. Lastly, they may also need to review the amount of passive investment income in the holding company as the passive income may affect the small business deduction for the operating company.

You may decide to use a family trust when implementing your estate freeze. This may allow you to retain some control of the common shares by being one of the trustees of the trust. It may also provide flexibility in determining who gets the income from the common shares and who will ultimately receive the common shares held by the family trust. One downside to using a family trust is that this indirect ownership structure may limit the ability to split income (under the TOSI rules) with family members who are not actively involved in the business.

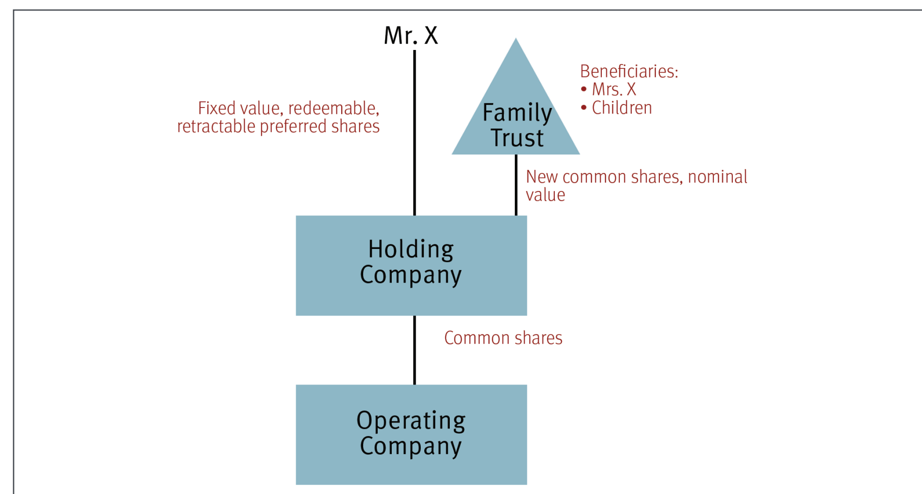
There are pros and cons to each structure but a qualified tax advisor can advise you on the best way to structure your estate freeze based on your circumstances and objectives.

The following diagrams illustrate common post-estate freeze structures (these are not all-inclusive).

Post-estate freeze with family trust

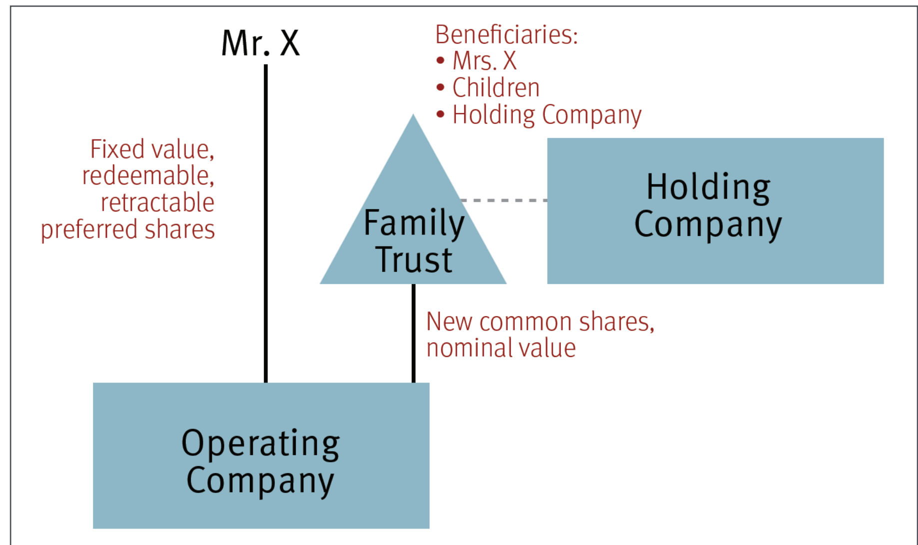


Post-estate freeze with family trust and holding company



A proper valuation of the shares being frozen is critical to a successful estate freeze.

Post-estate freeze with holding company as beneficiary of family trust



Other considerations

Valuation of your property

A proper valuation of the shares being frozen is critical to a successful estate freeze. If the property being frozen is valued below its fair market value, you may have to realize a capital gain equal to amount of the undervaluation. Alternatively, if the valuation of the shares being frozen is too high, you may have to recognize a taxable benefit. As a precaution against valuation errors, the transfer documents (in regard to property being transferred to a corporation) could contain a price adjustment clause that allows the parties to adjust the purchase price if the CRA determines that the fair market value of the transferred property was greater than or less than the price used for the freeze transaction.

Control

While your goal may be to freeze your tax liability on death and transfer the future growth of your assets to your family members, you may wish to maintain control over your corporation. You may be able to maintain control if the preferred shares issued to you in the estate freeze have special voting rights and/or by limiting the voting rights on the growth shares issued to your family members. An alternative strategy is to use a family trust to hold the growth shares rather than issuing the shares directly to your spouse and/or children. By putting the new common shares in a family trust, you may be able to maintain some control if you are one of the trustees of the trust. In addition, you may have the flexibility to determine which beneficiaries to distribute the income to every year and ultimately which beneficiaries to distribute the shares to at a later date.

U.S. persons

If you or your intended beneficiaries are U.S. persons (U.S. citizens, green card holders, or residents), an estate freeze may not be an effective strategy as there could be U.S. gift tax and adverse tax consequences associated with the U.S. grantor trust rules. It is important to speak with a qualified tax advisor that is familiar with cross-border issues.

Changes to your circumstances – modifying an estate freeze

Your circumstances are always changing and in some situations, the estate freeze you have put in place may no longer meet your needs. You may find that you would like to have access to a larger share of the assets in your corporation than the value of your frozen shares provide or receive

more income from the corporation. A well planned flexible estate freeze will provide the possibility to transfer additional income or capital to you. This type of estate freeze is often referred to as a "gel" instead of a freeze.

A common method of implementing a gel is to include you (as well as your spouse and/or children) as a beneficiary of the discretionary family trust used in your estate freeze. This allows you to have access to income and capital related to the new common shares owned by the trust. Since the trust is a discretionary family trust, there is flexibility in determining which of the beneficiaries will receive the future income and capital in the trust. The trustees can decide to pay you more income through the trust or not. They can also decide to distribute some of the common shares to you as a capital beneficiary of the trust. If you are one of the trustees you may have some influence on those decisions. It is very important in structuring a gel to ensure the attribution rules are not triggered. As discussed in the section on attribution, great care must be exercised in picking the settlor, trustee/s, income and capital beneficiaries, drafting the trust terms and choosing the steps used to implement the estate freeze.

What if you did not plan for a flexible estate freeze? An estate freeze still may not necessarily be set in stone. There may be opportunities to transfer additional income or capital to you. This may be possible without unwinding the freeze structure, using a method referred to as a "melt" or by reversing all or a portion of the freeze, referred to as a "thaw".

A melt is an arrangement where you divert part of the future appreciation of your corporation back to you after the estate freeze without modifying the new corporate structure. There are many ways to achieve this, such as increasing the amount of dividends declared on your frozen preferred shares; paying or increasing your salary and bonus; charging management fees; or through share redemption of your frozen shares. These methods allow you to extract funds from your corporation to fund your lifestyle expenses without implementing another corporate reorganization. An estate freeze along with slowly redeeming your frozen preferred shares allows you to gradually reduce the size of your estate and the taxes payable on your death. This technique of doing an estate freeze and then slowly redeeming your frozen preferred shares is sometimes referred to as a "wasting freeze".

A "thaw" refers to the process of unwinding an estate freeze. If instead of an estate freeze you implemented a gel (discussed previously), where you are also a capital beneficiary of the discretionary family trust that received the growth shares, the growth shares could be distributed to you from the trust, thereby undoing the estate freeze. It should generally be possible for the family trust to distribute the common shares to you, as a capital beneficiary of the trust, on a tax-deferred basis.

A second option for a thaw is converting your frozen preferred shares to common shares. It may be possible to do this on a tax-deferred basis if your preferred shares have a conversion privilege.

A third option for implementing a thaw is to acquire the common shares (growth shares) from the shareholders that received them in the estate freeze. The transfer of the common shares owned directly by shareholders to you may result in an immediate capital gain to those shareholders if the value of the common shares has appreciated since the freeze was implemented. If the shares of the corporation are QSBC shares, the shareholders may be able to use their LCGE to eliminate the capital gains tax payable on a thaw.

If the value of your corporation decreases after a freeze instead of appreciating in value, you may be able to refreeze at a lower value. The refreeze can be done by implementing an estate freeze of your preferred shares at the new lower value. This is beneficial since it lowers your estate value thereby reducing your capital gains tax on death and allowing more growth to pass to the next generation, assuming the value of the company increases after the refreeze.

All of these methods of modifying an estate freeze could potentially have tax implications if not properly executed. This means that they should not be attempted without the assistance of a qualified tax advisor.

Start planning today

As part of your estate plan, you may want to consider an estate freeze if you already own sufficient assets to fund your retirement. It is important to start planning early to ensure that you can transfer any excess growth to your intended beneficiaries. Further, if you have implemented a freeze, it is important to monitor your circumstances to ensure that the freeze continues to meet your needs.

An estate freeze is complex and must take into consideration your lifestyle and estate objectives. Speak with a qualified tax and/or legal advisor to determine if this strategy is right for you and to help you engage the right experts to implement an estate freeze.

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