

## Estate Freeze

### An Invaluable Estate Planning Strategy



An estate freeze is an estate planning strategy used to minimize taxes by limiting the growth of capital property held by you during your lifetime and passing any future growth in the capital property to your heirs (or to a trust for their benefit). This article illustrates a typical estate freeze and explores the reasons it may be a useful tool in business succession planning.

An estate freeze transaction allows a business owner (the freezor) to freeze the current value of an asset, typically private company shares, at its current fair market value (FMV). This is commonly done by exchanging common shares in a company for fixed value preferred shares of equal value. New common shares (growth shares) are then subscribed to for a nominal amount by family members (or a trust in their favour). Under the estate freeze strategy, the business owner can effectively pass on the future growth of the company to those family members. Such a transaction can be accomplished on a tax deferred basis so that there will be no tax payable by the freezor until the freezor dies, sells or redeems the preferred shares. Tax will only be payable by the freezor on the frozen value, thereby freezing and limiting the tax liability on disposition of the freeze shares. Where a trust is involved, there are planning considerations that are beyond the scope of this article that should be discussed with a tax and legal advisor.

## Typical Estate Freeze Situation

Harry Putter owns the shares of Putter Inc., a company that he started years ago. Putter Inc. is now worth \$15 million. Harry is getting older and feels that he has accumulated enough money (i.e., \$5 million in a cash account) that he can afford to do other things. He is concerned about the tax liability that may arise when he dies.

The company is currently well managed under the guidance of his son Larry, and Harry expects it to grow in value going forward. Harry plans on leaving the business to Larry but is not yet ready to give him voting control. Harry asks you for suggestions.

In the example above, Harry may be a good candidate for an estate freeze strategy. By implementing an estate freeze, Harry will be able to freeze all or part of the value of the growth assets (the original common shares of Putter Inc.) up to the FMV of \$15 million and issue new common shares to Larry, such that some or all of the future growth of those shares may be shifted to his son. Although Harry will still be liable for tax associated with the frozen amount (up to \$15 million) he will not be liable for tax on the future growth of Putter Inc. Instead, the tax liability on the future growth will be subject to tax in the hands of Larry when he sells his shares or upon his death. Harry can also structure the estate freeze in such a way that he retains voting control over the management of the business.

## Benefits of an Estate Freeze

### 1. “Capping” the Capital Gains Tax Liability

The primary purpose of this strategy is so that any future increase in the value of the company accrues to other individuals (usually the next generation of family members). As a result, the freezor’s capital gains tax liability is “capped” (i.e. frozen) and future growth of the asset will

not be taxed in the hands of the freezor, either during his or her lifetime or upon death.

To provide the liquidity to fund the future capital gains tax liability on the “frozen value”, life insurance solutions may be considered to pay the tax liability on the death of the freezor.

**Note:** Normally, if you were to gift or sell any of the frozen value of a company to a child (or a trust in their favour), for tax purposes, it generally would be considered to be a deemed disposition and potentially trigger immediate tax consequences.

### 2. Maintaining Control

Although the freezor may want to have the benefit of future growth on business assets accrue to his or her children, he or she may not wish to relinquish control over the business. The estate freeze is often designed in such a way to ensure that voting control over the direction of the business is, at least initially, retained by the freezor.

### 3. Crystallization of the Lifetime Capital Gains Exemption (LCGE) by the Freezor

The term “crystallization” refers to the process of purposely triggering a capital gain at a time when the shares of the corporation qualify for the LCGE. It is sometimes done during an estate freeze so that:

- It removes the need to continuously monitor that the shares meet the qualifications for the LCGE; and
- It ensures that you will have benefitted from the LCGE in case it is eliminated or reduced by the government before a third-party sale can take place.

The LCGE is available to Canadian residents to shelter capital gains resulting from the disposition of shares of qualified small business corporations (QSBC). Generally speaking, a share of a QSBC is one that satisfies all three of the following criteria:

- at the time of sale, it was a share of the capital stock of a small business corporation, and it was owned by you, your spouse or common-law partner, or a partnership of which you were a member
- throughout the 24 months immediately before the share was disposed of, it was a share of a Canadian-

controlled private corporation and more than 50% of the fair market value of the assets of the corporation were:

- used mainly in an active business carried on primarily in Canada by the Canadian-controlled private corporation, or by a related corporation;
  - certain shares or debts of qualifying connected corporations; or
  - a combination of the assets noted above
- throughout the 24 months immediately before the share was disposed of, no one owned the share other than you, a partnership of which you were a member, or a person related to you. The LCGE which may shelter capital gains up to \$883,384<sup>1</sup> (2020) per shareholder tax-free<sup>2</sup>, can be “crystallized” by the freezer at the time of the freeze—or its use deferred until later depending on the future plans for the company and an assessment by your tax advisor.

#### 4. Use of the LCGE by other Family Members

Assuming that the LCGE is still available at the time the family member shareholders (or a trust in their favour) dispose of their shares, and the QSBC tests are satisfied, there is the potential for multiple family members to use their LCGE’s to shield capital gains from a future sale of shares of the business. For example, a family of four shareholders could potentially shelter up to \$3.5 million (2020) in capital gains by using their LCGE on the future sale of shares of the family business.

#### 5. Potential to Income Split with Family Members

In 2018, the ability to income split with family members through a private corporation in Canada was significantly restricted by the implementation of the so-called Tax on Split Income (TOSI) Rules set out in the *Income Tax Act (ITA)*. However, there are a number of family income splitting opportunities still available depending on age, past and present contributions made by family members to the business, type of business activities and other factors. For example, family members who work or have worked in the business or, for certain non-professional corporations where less than 90% of the “business income” was derived from providing services<sup>3</sup>, family members who directly own at least 10% of the votes and value of the

corporation may still be able to take advantage of income splitting strategies. As well, for certain shareholders of private companies who have reached age 65<sup>4</sup>, it is possible to income split with spouses (to parallel current pension income splitting rules). While the technical aspects of the TOSI Rules are complex, it is worth discussing income splitting opportunities with your tax advisor if you are contemplating an estate freeze transaction.

In addition to the TOSI Rules, the ITA also includes corporate attribution rules which would reduce or eliminate the income splitting benefit by deeming (or attributing) interest income on the property to the freezer. Corporate attribution may apply if one of the main purposes of the estate freeze is to reduce the income of the transferor and to benefit a spouse or a minor child. It is important to seek tax and legal advice to ensure the corporate attribution rules do not apply.

## Other Methods of Transferring a Family Business

### 1. Gifting of the Shares

If you gift the shares of the family corporation to your children or transfer those shares to a trust for their benefit, the tax rules will deem you to have disposed of those shares at FMV and you may have to pay tax on the gains of those shares in the year you made the gift. However, the recipients will be entitled to utilize the FMV as the adjusted cost base (“ACB”) on any future transaction.

**Note:** If the shares are QSBC shares and are gifted, it may be possible to shelter gains utilizing the LCGE of \$883,384 (2020).

In addition to the immediate capital gains tax considerations, if the beneficiaries of the gift are related or non-arm’s length minor children, then attribution rules stipulate that income earned on the assets be attributed back to the original owner of the asset.

### 2. Sale at Less Than Fair Market Value

If you sell the shares to your children at less than FMV, your sale is deemed to have occurred at the FMV. This can potentially result in double taxation. Your capital

gain or loss at disposition will be based on the FMV of the shares and not the actual sale price if below FMV. On the other hand, your children's ACB will be based on the price at which they acquired the shares (i.e. the "below FMV" price). The following example illustrates what happens when John sells his shares to his daughter Susan at a price below the FMV, Susan then re-sells the shares to an arms-length party later at FMV.

John Sells Shares to his Daughter Susan for \$75,000 (\$25,000 less than FMV)	Susan Later Sells the same Shares to an Arm's-Length Party for \$150,000
John's ACB: \$50,000	
John's Actual Proceeds of disposition: \$75,000	Susan's ACB: \$75,000
Actual FMV at disposition: \$100,000	Susan's FMV at disposition \$150,000
John's Capital Gain: \$50,000 (100,000-50,000)	Susan's Capital gain: \$75,000 (150,000-75,000)
John & Susan have now both paid a capital gain on the same \$25,000	

In other words, if you sell to a related party at a discount below FMV, you will still owe tax as if you sold at FMV, yet on any subsequent sale, the related party does not have the benefit of a higher ACB so the family has effectively paid "double tax" on a portion of the sale, as illustrated above.

**Note:** Beware when selling or gifting shares to a related corporation. Section 84.1 of the ITA may operate to re-characterize the capital gain as a taxable "dividend", and therefore, the selling party/giftor may lose the benefit of the LCGE and/or preferential capital gains tax treatment.

As well, Section 84.1 may operate to deny the gift recipient the higher ACB on the shares one might expect in such a transaction.

In addition, when selling shares to a child, it may be possible to defer the recognition of some of the capital gain for up to 10 years by claiming a "reserve" under the ITA. For example, if a promissory note is taken back as consideration for part of the sale price, you may be able to defer the recognition of the capital gain for tax purposes in the same proportion as the payments are actually received for up to 10 tax years.

## When to Consider a Refreeze Strategy

If you have already implemented an estate freeze, but your business is no longer as valuable as it was at the time of the original freeze, you may wish to consider a refreeze strategy. A refreeze strategy provides an opportunity for a freezor to reset their fixed value interest in the business to the current (reduced) FMV and reissue new common shares to family member(s) without any immediate tax. Assuming the business regains its value in the future, the freezor will have passed that gain to the new common shareholder(s) and thereby "capped" the freezor's capital gains tax liability at an even lower amount than was achieved on the original estate freeze.

## An Example of the “Refreeze” Strategy

Continuing with the example above, let’s say Harry Putter took advice 2 years ago and implemented an estate freeze when his common shares of Putter Inc. were valued at \$15 million. As part of that strategy, Harry exchanged his common shares in Putter Inc. for “fixed value” voting preferred shares of equal value (\$15 million) and issued new non-voting common shares to his son, Larry, for nominal value.

Due to a recent economic downturn, Putter Inc. experienced a drastic drop in sales and net profits were reduced significantly. As a result, Putter Inc. is now valued at \$10 million. While this may be troubling, Harry and Larry believe the downturn is temporary, and that the business will recover over the medium-term and remain strong.

With Larry’s co-operation, Harry can exchange his voting preferred shares (with a face value of \$15 million) for a new class of voting preferred shares valued at the current FMV (\$10 million) and issue new non-voting common shares (growth shares) to Larry for nominal cost.

Through this refreeze strategy, Harry effectively reset the fixed value of his preferred shares to the current \$10 million market value. In the future, when Putter Inc. recovers to its former value of \$15 million, because of the refreeze, Harry has deferred the capital gains tax liability on that \$5 million gain (which would otherwise have been triggered on his death), and he has successfully passed that \$5 million gain into Larry’s hands without triggering any immediate tax. The lower FMV of Putter Inc. has created a unique planning opportunity for Harry to undo his previous estate freeze by implementing a refreeze strategy.

In considering an estate freeze or refreeze strategy, a business owner must be satisfied that they have sufficient wealth to fund their retirement. If there is uncertainty as to whether there is sufficient wealth, a trust may be created and used as the new shareholder of the business to ensure the business owner freezing, or refreezing, their interest continues to have access to the future growth of the business.

Like the estate freeze transaction, a refreeze strategy can be accomplished on a tax-deferred basis so that there will be no tax payable by the freezer until the freezer dies, sells or redeems the new preferred shares.

## Other Considerations

### Grinding the Small Business Deduction

If your children or other family members own shares in other private companies and they acquire, directly or indirectly, shares in your company, either by way of a freeze, refreeze or otherwise, the companies may be associated for tax purposes. Rules introduced in 2018 also restrict the small business deduction for companies and any associated companies where they earn passive investment income of \$50,000 or more combined.

### Relationship Breakdowns

Selling shares (rather than gifting shares) to your children can also expose those shares to spousal and common-law partner claims in the event of a child’s relationship breakdown in certain provinces. For example, in Ontario, shares that are sold to a child may be subject to an equalization claim on the marriage breakdown of a recipient child in the absence of a domestic contract which stipulates otherwise. In the case of a gift, the *Ontario Family Law Act* provides that a gift and any income derived from the gift may be exempt from an equalization claim by the spouse where the gift was made after the marriage of the child and was made subject to the express condition that the income derived from the gift would not be included in net family property. Since provincial laws may differ, check with your advisor for the laws that may apply to your specific situation.

## Alternative Minimum Tax

In any year you or a family member utilizes the LCGE, you (or the family member) may be liable for Alternative Minimum Tax (AMT) depending on the taxpayer's total income in the applicable tax year. While AMT can be recovered by the taxpayer up to 7 years in the future, it may be an unwelcome surprise in the planning process.

Apart from the different tax consequences as outlined above, one essential distinction between the estate freeze and other methods of transferring such assets is the separation between the value of the assets and the control of the assets. If you wish to transfer the future growth of your business to family members without losing control of your business or having to pay immediate taxes, then you may want to consider an estate freeze.

## Considerations

An estate freeze or refreeze strategy can be a critical component of your business succession plan and your estate plan. As estate freezes and refreezes are complicated transactions, speak with your TD advisor and your tax and legal advisors to understand if an estate freeze, or a refreeze, is appropriate for your situation.



<sup>1</sup>This amount is indexed annually for inflation. The LCGE applicable on the disposition of qualified farm or fishing property is the greater of (1) \$1 million; and (2) the indexed LCGE applicable to the capital gains realized on the disposition of QSBC shares.

<sup>2</sup>The LCGE that may be claimed is subject to (a) the annual gains limit; (b) the cumulative gains limit; and (c) the amount of unused LCGE available to the taxpayer.

<sup>3</sup>And less than 10% of the income of the corporation was from another related business.

<sup>4</sup>Or would have reached 65, if deceased.

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