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Estate freeze

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

On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.

Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.

The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

If you are the sole owner of your corporation, you may be wondering if there are other ways to structure the ownership of your corporation to improve tax efficiency and simplify planning for your estate. An estate freeze is a tool that can be used to restructure the ownership of your corporation by limiting the value of your assets and transferring future growth to your family. 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. For the purposes of this article, the intended beneficiaries will be your spouse and children. Keep in mind, however, that you can implement an estate freeze in favour of unrelated key employees of your business or any other beneficiaries.

Note the term "spouse" used in this article also refers to common-law partner or same-sex partner.

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.

What is an estate freeze?

Estate freeze is the term commonly given to a transaction where you lock-in or "freeze" the value of appreciating assets. Typically, you would then transfer 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 of your business) for another type of property that has no growth potential (e.g. fixed-value preferred shares of your business). If there is no potential for the property to increase in value, it will usually be preferable not to implement a freeze.

Generally, when you dispose of property or trigger a deemed disposition on death, you will realize any capital gains accrued on your property and have a resulting tax liability. The most common exception to this is when you transfer property to a spouse. If you intend to sell your property or gift your property to someone other than your spouse, the potential capital gains tax could be substantial, especially if the property is appreciating in value rapidly. By implementing an estate freeze, you freeze the accrued capital gain on your property and transfer the future capital gains to your intended beneficiaries, such as your children, without triggering immediate tax consequences. This allows you to plan for the tax that will ultimately be payable upon the eventual disposition or deemed disposition of your property on death because the value of the frozen property and the accrued capital gain on that property are known and will not change. The tax liability on the future growth is deferred and is transferred to the next generation.

When would you consider an estate freeze?

If you have assets that will sufficiently fund your retirement, you may want to consider an estate freeze if you would like to achieve one or more of the following objectives:

- You want to minimize and defer tax.
- You operate a business and you would like to have family members take over the business.
- 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), and therefore, you can benefit from income splitting with your children.
- You own an operating company that has grown to a size where you would use up all of your lifetime capital gains exemption (LCGE) on the disposition of the shares of the corporation. You 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.
- You have an operating company and one or more of your children would like to continue the family business after you retire or after your death.

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 children and/or spouse, you limit the amount of tax you will pay on the sale or deemed disposition of the shares of your corporation. In addition, if your children and/or spouse are in a lower income tax bracket, they will pay less tax than

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

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 when you sell your shares of the corporation or are deemed to have disposed of the shares. The future growth of the corporation is passed on to your children or spouse. 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 children or spouse dispose of or are deemed to have disposed of their shares of the corporation.

If the assets to be frozen (e.g. the shares of the corporation) are likely to be sold soon after your death, implementing an estate freeze may not be the best solution if tax-deferral is your goal.

Be sure to talk to your children and/or spouse 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 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 the 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. However, your corporation should not pay dividends to any minors (less than 18 years old) or "kiddie tax" will apply to these dividends. Therefore, you will only benefit from this income splitting strategy if your corporation pays a dividend to lower-income adult family members. Kiddie tax is designed to discourage business owners from income splitting with non-arm's length minors by charging the highest marginal tax rate on dividends minors receive from private corporations and by disallowing the minor from claiming personal tax credits other than the dividend tax credit.

You are likely able to income split a greater amount with your family members by paying dividends rather than paying a family member salary. This is largely because salaries must be "reasonable". The amount paid as salary to your spouse or children must be a fair reflection of the amount and type of work they do for the business.

Appendix 1 provides an illustration of the potential tax savings from income splitting after implementing an estate freeze.

Multiplying the lifetime capital gains exemption

There is a significant tax break on the capital gains you realize on

An estate freeze will limit the size of your estate and therefore reduce probate fees payable at death.

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's (CRA) website). For more information regarding the types of shares that qualify as QSBC shares, please ask an RBC advisor for our article titled, "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 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.

Appendix 1 provides an illustration of the potential tax savings from the multiplication of the LCGE after implementing an estate freeze.

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 at death. Please note that there are other strategies that you can employ to reduce probate fees. For example, if you are 65 years of age, you may want to consider an alter ego or joint partner trust. 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 setting up 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. Speak with a qualified tax advisor to determine the benefits versus the costs of implementing a freeze.

Attribution

If the estate freeze is not properly structured, one of the many rules in the Income Tax Act that can apply is the attribution rules. 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

If the value of your corporation isn't large enough, it may be too soon to implement an estate freeze. In this case, you may choose to implement a partial estate freeze.

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 to 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 an estate freeze is to reduce your income and benefit your spouse and 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 is paid or made payable to your spouse or a non-arm's length minor. 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. There are ways to manage corporate attribution. A qualified tax advisor should be familiar with the issues and methods of mitigating corporate attribution.

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, 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 tax laws require that unrealized gains on the trust's assets be declared every 21-years. This means that the trust must report all accumulated gains 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 the beneficiary to be taxed in their hands.

Even though a trust must pretend to dispose of everything and pay the tax, it does not mean the trust must be wound-up. Once the tax is paid, the trust continues to operate as it did before.

You'll want to consider the timing if you are utilizing a trust in the estate freeze. If you expect the freeze to

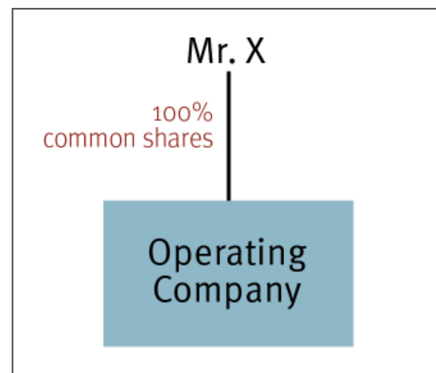
If you are planning to use a holding company but you want to maintain the ability to claim the LCGE on the sale of your operating company, careful planning should be considered.

be in place for longer than 21 years, you'll want to take the necessary steps to plan for the deemed disposition. Speak to a qualified tax and/or legal advisor regarding the planning that may be available.

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 transfers 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 will 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 your corporation is considering this type of tax planning, you should involve a qualified tax professional to ensure your tax-free inter-corporate dividends will not be re-characterized into capital gains which are taxable.

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 continue holding 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.

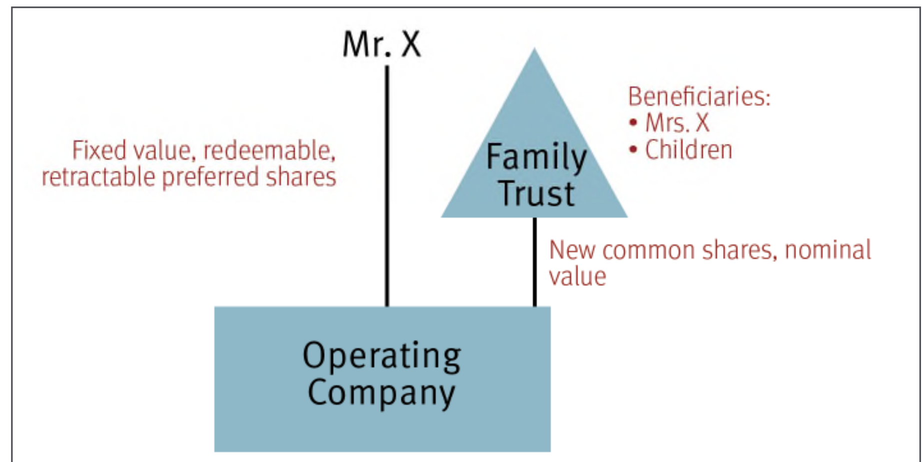
A qualified tax advisor can advise you on the best way to structure your estate freeze based on your circumstances and objectives.

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 and 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.

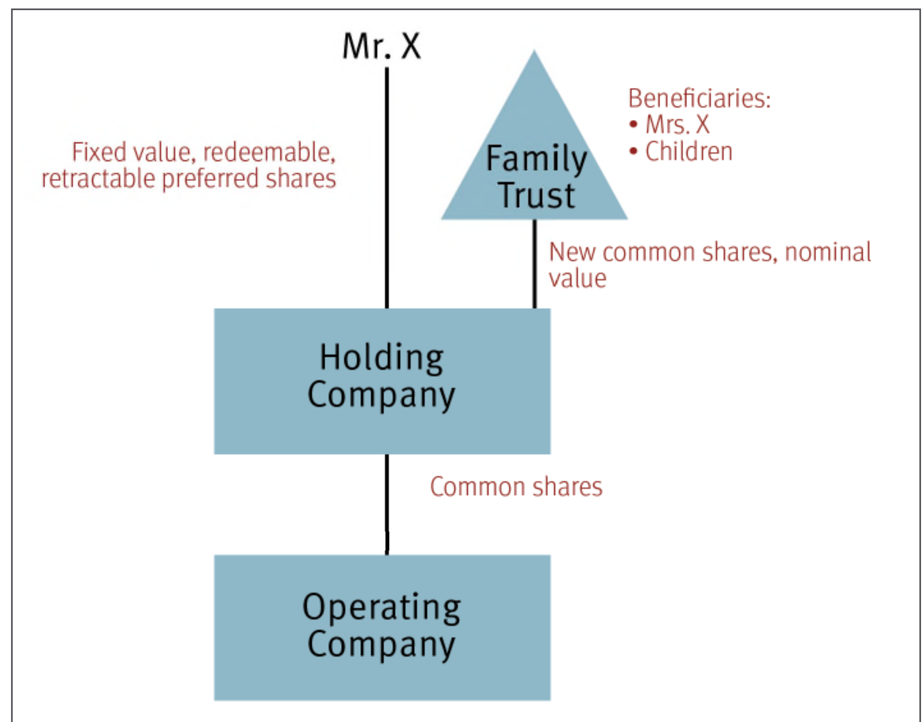
There are pros and cons to each structure but a qualified tax advisor can advise you on the best way to structure your estate freeze based on your circumstances and objectives.

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

Post-estate freeze with family trust

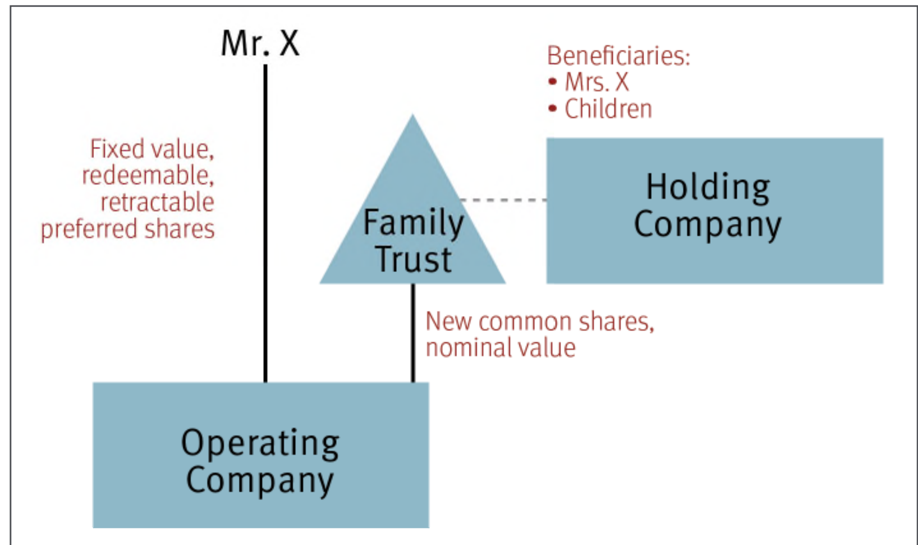


Post-estate freeze with family trust and holding company



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.

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



Other considerations

Valuation of your property

A proper valuation of the shares or assets 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 assets or 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 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. As mentioned previously, 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

It is prudent to refrain from having U.S. persons (U.S. citizen, green card holder, or resident) involved in an estate freeze in order to avoid adverse tax consequences caused by the U.S. gift tax and U.S. grantor trust rules. It is important to speak with a qualified tax advisor that is familiar with cross-border issues if you or your intended beneficiaries are U.S. persons.

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 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, 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. Some of the ways to implement a melt is by 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. If this is not an option then it may be possible to convert your frozen preferred shares to common shares. A third option is to acquire the common shares (growth shares) from the shareholders that received them on the estate freeze.

It may be possible to convert your preferred shares to common shares on a tax-deferred basis if the preferred shares have a conversion privilege. Also, 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.

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 a tax implication 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 can be very complex and must take into consideration your estate objectives and both tax and various legal issues. 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.

This article outlines strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.

Appendix 1 – Potential tax savings after estate freeze

John is a 50-year-old widowed business owner who is subject to tax at a rate of 50%. We have assumed a tax rate of 50% on all of his income from the corporation for simplicity. He has three adult children, all of whom are attending university. His business is an active business. John suspects that none of his children will earn a significant amount of income for at least the next five years. We have also assumed that John and his children reside in a province where an individual can receive up to $30,000 of non-eligible dividends tax-free if they have no other income or they can receive up to $50,000 of eligible dividends tax-free if they have no other income.

At present, John operates a corporation worth $2.5 million. The adjusted cost base of his shares is negligible. Sometime in the future, he estimates that his operating company will be worth approximately $5 million, at which time he will likely sell all the shares of his business to a third party. His business earns $880,000 annually after expenses excluding salary expense. John pays himself $380,000 in salary. Thus, the annual taxable income of the company is $500,000. The corporation is subject to 15% tax on the first $500,000 of active business income and is taxable at 27% on income above $500,000.

John wishes to support his children by providing each of his children with $30,000 annually to fund their tuition and living expenses for the next five years. If John withdraws $380,000 in salary each year, he will only be left with $100,000 (ignoring the effects of any payroll taxes) after paying income taxes and providing support to his children.

However, if John implements an estate freeze to income split with his children, his family will save taxes and have the same amount of after-tax funds but his corporation will be left with more after-tax dollars to invest.

The following table compares the amount of taxes payable over the next five years by John and his corporation if he were to leave things as is with the tax payable by John, his children and his corporation if he were to implement an estate freeze. The table also shows the tax savings that may result on the sale of shares of John's corporation before an estate freeze versus after an estate freeze where access to the LCGE may be multiplied. In this illustration, we assume that John and his three children are able to each claim an $800,000 LCGE. We also assume that in the year of the sale John and each of the children have a 50% tax rate on the taxable capital gain to keep the example simple.

Tax savings by income splitting with children

		Without Estate Freeze		With Estate Freeze
Annual surplus earned by the corporation		880,000		880,000
Annual salary paid to John		380,000		200,000
Annual taxable income of corporation		500,00		680,000
Annual corporate tax @ 15% on first $500K and 27% on excess	A	75,000		123,600
Annual amount available for dividends		425,000		556,400
Annual dividends paid to children		–		90,000
Annual after-tax funds left in corporation		425,000	*	466,400
Annual tax paid by John @ 50%	B	190,000		100,000
Annual tax paid by children	C	–		–
Annual after-tax amount to family		190,000		190,000
Total annual corporate and personal taxes paid	A + B = C	265,000		223,600
Annual tax savings				**41,400**
Total corporate and personal taxes paid over 5 year period		1,325,000		1,118,000
Total tax savings over 5 year period				**207,000**

Tax savings from multiplication of LCGE

Proceeds from sale of business (ACB = 0)		5,000,000	*	5,000,000
LCGE		800,000		3,200,000
Taxable capital gain		2,100,000		900,000
Tax of taxable capital gain @ 50%		1,050,000		450,000
Tax savings				**600,000**

* We have assumed that the additional funds accumulating in the corporation would be removed before the corporation is sold.

In this example, John saves about $41,400 in taxes annually by income splitting with his children after implementing an estate freeze. This adds up to $207,000 in tax savings over a 5-year period. In addition, John and his family can save $600,000 in taxes on the sale of the shares of the corporation by John and each of his three children claiming an $800,000 LCGE.

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

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