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Succession Planning

The Estate Freeze

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An often-quoted statistic is that only about 10 per cent of family-owned businesses remain sustainable into the third generation. This has a lot to do with the lack of proper planning while the founding parents are still alive.

If you (or your clients) carry on a family business and are considering bringing in the next generation, then it may be time to think about how to best introduce your kids into the family business in the most tax-efficient manner. And if you are not sure your kids want to carry on the family tradition, a business succession plan can also be an important tool in minimizing taxes on an eventual sale of the business. So regardless of your goals as a family business owner, it may still be time to think about alternative structuring for your business by perhaps implementing an Estate Freeze of your operating business (“Opco “).

What is an Estate Freeze? An Estate Freeze refers to the transferral of future growth in the value of a business, investments, or other assets into the hands of your kids. An estate freeze typically limits the value of your estate in relation to your corporation holdings to the value of Opco at the date the freeze is implemented (don’t worry, you still retain the current value of Opco, although often in a different form). Accordingly, capital gains and other tax exposure to the future growth that would arise when the assets pass from you to your kids are avoided.

In order to get the full benefit of an Estate Freeze, your shares in Opco will be reorganized into a class of “freeze “ shares that will not be entitled to any future growth (but will still get the benefit of dividends based on a pre-determined date). New growth shares can then be issued to your kids (or, a discretionary family trust for the benefit of your kids) without triggering any tax hits. Any future growth in the value of the assets held by Opco will then accrue to these growth shares (and not to you).

Why do an Estate Freeze?

Why do we bother to implement most tax-related strategies? To save tax, of course. But you may be wondering just why you would give up future growth? Well, chances are that you may have acquired enough value in your current assets to keep you happy until the twilight of your life. By putting in place an Estate Freeze, you will maximize the value of your estate that will ultimately pass to your beneficiaries.

As we all know, we can’t avoid death and taxes. And sadly, these two go hand in hand. Upon your death, you are deemed to have disposed of all of your assets at their fair market value and your estate is required to pay the capital gains tax on this “deemed disposition “. The implementation of an Estate Freeze will effectively “freeze “ the value of your inter-

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est in Opco to present day value, with any future growth in Opco flowing in favour of your kids or a family trust (assuming you give them the growth in Opco). This means that your interest in Opco will no longer grow in value. The upside, however, is that the capital gains and other tax that would otherwise be triggered on your death will be limited to the frozen value of Opco; future growth in Opco that will have arisen from the date of the Estate Freeze to your death will only be taxable upon the death or sale of the shares by your kids. So less tax being paid also means your beneficiaries will receive more (and CanRev less)

In order to maximize the benefit of the Estate Freeze, this strategy is usually implemented when Opco (or the assets in Opco) are expected to appreciate in the future. If the assets are expected to depreciate, it would usually be preferable to hold off freezing. Also, if you feel that the current value of the assets are not high enough for you to live off of for the rest of your life, you may want to think twice about freezing.

In addition to avoiding capital gains tax upon death, there are a number of other tax purposes an Estate Freeze may serve.

Income splitting

The up-side of future growth being diverted to your kids is that any dividend income or capital gains arising from the shares in Opco will be taxed in your kids' hands. And, chances are that your kids will be subject to a lower marginal tax rate than you, which results in tax savings. Although there are a number of income tax rules (the "attribution rules " and "kiddie tax ") which are designed to thwart this objective when your children are minors,, it is quite possible to implement successful income-splitting strategies within the context of a freeze, notwithstanding these rules. My advice is to ensure that you get proper tax advice to make sure that you don't trip into the attribution rules when implementing an Estate Freeze.

Multiplying the Capital Gains Exemption

Another upside is the ability to multiply the $800,000 lifetime capital gains exemption on the sale of certain shares of a corporation. If an Estate Freeze is not implemented, and you are the sole shareholder at the time of a sale (and, assuming your shares qualify) you will be limited to $800,000 tax-free. However, if you implement an estate freeze and introduce your kids as shareholders (or, a family trust on behalf of your kids), this $800,000 tax-free amount can be multiplied by the number of kids to whom you give shares(either directly or through a family trust). This can add up to a lot of tax savings. Keep in mind, however, that there are a number of rules that need to be met in order to take advantage of this $800,000 exemption, including a 24- month holding period before you can take advantage of this provision. Therefore, if you think an eventual sale of your business in on the horizon, you may want to think about implementing an Estate Freeze right away so that you can meet the 24-month holding period and also allow for enough value to accrue to the growth shares in favour of your kids.

Creditor protection

If you're concerned that you could potentially be subject to claims by creditors as a result of personal guarantees, judgment creditors or the like, then you may be able to take some comfort in having shares held by your kids, or better yet, a discretionary family trust which holds shares in favour for them.

Non-tax consideration

Of course, the main objective of an Estate Freeze is to be able to introduce your children into the family business on a tax-free basis. If you were to simply gift shares to your children, you would be taxed on such transfer. However, an Estate Freeze is a legitimate tax planning structure that allows you to introduce your children as equity owners without triggering any tax. And the use of a family trust to hold the new growth shares for your children gives you the added benefit of being able to control those shares (i.e. you would do so by acting as a trustee of the trust) and giving you more time and flexibility in deciding when and how to distribute those growth shares among your children. ❐