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TAX STRATEGY

Estate planning in recessionary times

A silver lining — the estate freeze

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These days I'm constantly bombarded by the media and my own paranoia about the state of the markets and which firms are looking for creditor protection.

Despite all this doom and gloom, I believe that there is always a silver lining if you look hard enough.

When it comes to tax-planning, the silver lining is all about estate planning in recessionary times. When values are low, it is time to think about reducing your ultimate death tax liability.

If you have large income-earning assets, or carry on a business, you may want to consider transferring them (on a tax-deferred basis) to a corporation.

Or perhaps you may already have a corporation which carries on a business. In that case this may be the time to think about "freezing" your interest in the corporation, or operating company ("Opco"). In doing so, you would defer tax to future generations and reduce your eventual tax bill at death.

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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.

Basically, this means that you would be divested of future growth. An estate freeze typically limits the value of your estate in relationship to your corporation holdings to the value of Opco at the date the freeze is implemented. (You still retain the current value of Opco, although often in a different form.)

Accordingly, you avoid capital gains and other tax exposure on the future growth that would otherwise arise when the assets pass from you to your kids.

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 additional tax. Any future growth in the value of the assets held by Opco will then accrue to these growth shares (and not to you).

Why an estate freeze?

Why do we bother to implement most tax-related strategies? To save tax, of course. But you may be wondering, why would you 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.

As we all know, there are two things 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 interest in Opco to present day value and any future growth in Opco will flow in favour of your kids or a family trust.

This means that your interest in Opco will no longer grow in value. Therefore, 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 on your tax also means your ultimate beneficiaries will receive more – and CanRev less.

In order to maximize the benefit of the estate freeze, this strategy is usually implemented when 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. This is why an estate freeze has been a popular topic lately: with the market being depressed, it's an optimal time to think about freezing.

Of course, if you feel that the current value of the assets is not high enough for you to live off for the rest of your life, you may want to think twice of about freezing.

In addition to avoiding capital gains tax upon death, there are a number of other 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 will result in tax savings.

Although there are a number of income tax rules (the "attribution rules") designed to thwart this objective, it is possible to implement successful income-splitting strategies within the context of a freeze, notwithstanding these rules.

My advice is to consult a tax professional so that you don't trip into the attribution rules when implementing an estate freeze.

Another upside is the ability to multiply the $750,000 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 $750,000 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 tax-free $750,000 amount can be multiplied by the number of kids to whom you give the shares.

This can add up to a lot of tax savings. (Keep in mind, however, that there are a number of rules that apply when claiming this $750,000 exemption, including a 2-year holding period before you can take advantage of this provision.)

❑ Creditor protection

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

❑ Probate planning

Because an estate freeze limits the future growth of assets owned by you, it also limits the value of your estate at death – since the higher the value of your estate, the higher the probate tax will be.

Probate tax is highest in Ontario and British Columbia and, in both these provinces, probate planning has become an integral part of estate planning.

And if this is the case, then your dreaded tax bill upon death will be lower than it would be without an estate freeze, since all of that future appreciation has now been diverted to the next generation.

As mentioned before, and happily for your kids, this means that less tax is payable by your estate on your death, and that translates to more value to pass on to them.

And an extra plus – since you have transferred all of your assets to a company, the only real asset you own is the shares of that company.

Since shares of private companies are not subject to probate tax, you can put in place multiple wills (this strategy is available in Ontario). This would involve placing your assets that don't require probate (i.e. your shares in Opco) in one will and your other "probatable" assets in a second will so that you can avoid probate on your shares of Opco.

❑ Tax benefits of incorporating

If your assets are owned personally, it will be necessary for you to transfer your assets on a tax-deferred basis to a corporation in order to implement an estate freeze.

So, implementing a freeze may also serve to obtain or enhance the tax benefits of incorporation.

This might include creating a second small business base - i.e., by creating a new corporation to be frozen which is not associated with a pre-existing operating company.

Additionally, you can take advantage of the lower corporate tax rates (to the extent that you leave the cash in the corporate system). And with the corporate rates being reduced to quite low rates in future years, this alone could result in substantial tax savings. ❑