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Estate Freezes

Why They Still Matter

Samantha Prasad LL.B.

I've written about family-owned businesses and the benefits of implementing an estate freeze, which refers to the tax-deferred structure of introducing the next generation into the family company while also limiting the eventual death tax to the founders. While it's not only a good planning tool for succession planning (without it, only about 10 per cent of family-owned businesses remain sustainable into the third generation), a business succession plan can also be an important tool for minimizing taxes on an eventual sale of the business. However, with the changes to the private corporation rules as of 2018, and other odd attacks in the press, one may think that estate freezes are at thing of the past. However, despite the restricted ability to income split through an estate freeze structure (see discussion below), and regardless of your goals, as a family business owner, it may still be time to think about why an estate freeze is right for you.

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.
sprasad@mindengross.com

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 your corporation ("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 on the future growth that would otherwise arise when the assets pass from you to your kids on death are deferred to the next generation.

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 value). 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 be more efficient from a tax perspective, of course. But you may be wondering, "Why would I 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 interest in Opco to present-day value, and any future growth in Opco will flow 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. But the upside 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. It also means that 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 paid on your tax also means your beneficiaries will receive more.

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 is not high enough for you to live off of for the rest of your life, you may want to think twice of about freezing.

Income Splitting

Prior to 2018, an additional upside of having future growth diverted to your kids is that any dividend income or capital gains arising from the shares in Opco could be taxed in your kids' hands at lower tax rates. Although a number of income tax rules (the "attribution rules" and "kiddie tax") thwart this objective when your children are minors, it was quite possible to implement successful income-splitting strategies within the context of a freeze, notwithstanding these rules in favour of children once they turned 18. However, with the introduction of the Tax on Split Income (TOSI) rules in 2018, the general rule has now become that any income paid to family members, REGARDLESS of age, would be taxed at the highest tax rate, thereby rendering income splitting a non-event.

However, there are certain exceptions to the TOSI rules that may allow you to still income split with certain family members. For example: if your children are actually active in the business (i.e. spend on average 20 hours a week), or of they are 25 years or older and own the growth shares directly in a company that is not in the business of providing services, then it may be possible to income split. At the end of the day, the ability to income split within the context of an estate freeze has been restricted, but is not dead in the water. My advice is to ensure that you get proper tax advice when navigating the TOSI rules when implementing an estate freeze.

Multiplying the Capital Gains Exemption

It cannot be stressed enough about the advantages of multiplying the lifetime capital gains exemption on the sale of certain shares of a corporation (currently the exemption is $866,912 for 2019, indexed). 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 the one capital gains exemption. However, if you implement an estate freeze and introduce your kids as shareholders (or, a family trust on behalf of your kids), this $866,922 tax-free amount can be multiplied by the number of family members 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 capital gains 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 is 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.

Family Succession Planning

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 a 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 allowing you more time and flexibility in deciding when and how to distribute those growth shares among your children. ❑

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