Estate Planning 101

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The cornerstone of every successful family estate plan is the estate freeze. Estate freezes are often undertaken when individuals feel they have acquired enough value in their current assets to adequately provide for them for the remainder of their lives. Estate freezes are most commonly effected pursuant to the reorganization of the share capital of a corporation or the tax-free rollover of property into a corporation where held individually. In its most basic form, an individual exchanges his or her growth shares of a corporation or his or her interest in property held individually for new shares whose value is "frozen" at the fair market value of the growth shares or interest in property at the time of the freeze. Shares carrying the rights of future growth are issued to the next generation, either directly or pursuant to a family trust.

As the economy begins to recover from this past recession, it is an opportune time to implement an estate freeze, and in some cases a "refreeze" (discussed in greater detail below), in order to take advantage of reduced values while they are still low. It is also an ideal time to review old freeze structures to take recent developments into consideration (e.g., beneficiaries moving to the United States, family law considerations) so that any modifications to the freeze structure may be implemented at these reduced values.

Why Implement an Estate Freeze?

The most common reason for implementing an estate freeze is to limit death tax. Under current Canadian tax laws, an individual is deemed to have disposed of his or her assets upon death (unless transferred to a surviving spouse or qualifying spouse trust), and is subject to tax on the difference between the fair market value and the cost of those assets. An estate freeze limits this tax exposure by "freezing" the financial interest in the corporation or assets to its value at the time of the freeze. Any taxes owing on the growth from the time of the freeze may be deferred by a generation – sometimes longer. (As an aside, insurance is often acquired to fund the tax exposure upon death, and this exposure may be reduced through the use of corporate-owned insurance).

The crystallization of the Lifetime Capital Gains Exemption (the "LCGE") which allows for up to $750,000 in tax-free capital gains upon the disposition of certain shares if certain conditions are met) will often be utilized when implementing an estate freeze where it is available and its use is desirable. Upon exchanging his or her shares, an individual may crystallize the LCGE by electing into the (tax-free) gain of up to $750,000. Further, it is possible to facilitate the multiplication of the LCGE, if the proper structure is implemented, which would allow the beneficiaries of a family trust, for example, to utilize the LCGE. Estate freezes may also be structured to utilize various income-splitting techniques. While a number of rules have been introduced to prevent income splitting (attribution rules and the "Kiddie Tax," for example), it is still possible in certain circumstances to have dividends paid on, and capital gains arising from the sale of, growth shares taxed in the hands of a spouse and/or children who are subject to tax at lower rates.

Estate freezes are also often implemented for creditor protection purposes (if an individual is concerned with potential claims by creditors), for probate planning purposes (corporate interests may avoid probate taxes if multiple wills are used and the corporate interests are in a will separate from those assets that are subject to probate), and to take advantage of a number of benefits associated with incorporation (including lower corporate tax rates.)

Variations of the Basic Estate Freeze Structure

Where an individual is not prepared to give up all of his or her interest in the future growth of the corporation at the time of the freeze, a "partial freeze" can be implemented whereby the individual retains a portion of the future growth of the corporation. Alternatively, a "gel" may be implemented, which provides for the possibility of future growth accumulating for the benefit of the individual. Where family or financial circumstances change subsequent to the freeze, a "melt" may be implemented, whereby part of the growth of the corporation is diverted back to the individual without modifying the corporate structure, or a "thaw" may be undertaken, which causes an estate freeze to be unwound, including the growth that has accumulated to the next generation.

Where the value of a corporation has decreased from the time of the freeze, a “refreeze” is often implemented to modify the estate freeze, but not reverse it. Among other advantages, a refreeze further reduces the taxes owing on death. Transactions of this type were common during this past recession due to lower values, and, as mentioned above, may still be advantageous depending on the circumstances.

Shareholders’ Agreements

In anticipation of the next generation holding shares personally (which, if a family trust is utilized, is usually shortly before the 21st anniversary of the trust), a shareholders’ agreement will often be advisable. A shareholders’ agreement may limit the next generation’s rights during the lifetime of the individual so that the individual may continue to control the corporation, and perhaps more importantly, a shareholders’ agreement may become the constating document for the family business once the individual has passed away.

Post-Mortem Planning

A discussion of post-mortem planning is beyond the scope of this article, but it is important to note that there are a number of strategies available that may be implemented to minimize the double tax arising upon the deemed disposition of the individual or his or her surviving spouse’s interest in the corporation.