Estate Freeze - The Basics

An estate freeze is an estate planning strategy used to minimize taxes by limiting the growth of capital property held by you during your lifetime; any future growth in the capital property is transferred to your heirs as a result of the estate freeze.

This article illustrates a typical estate freeze and explores the reasons it is a useful tool in business succession planning. A comparison to other methods of business succession will be provided.

A Typical Estate Freeze Situation

Harry Putter owns the shares of Putter Inc., a company that he started years ago. Putter Inc. is now worth $15 million. Harry is getting older and feels that he has accumulated enough money (i.e. $5 million in a cash account) that he can afford to do other things. He is concerned about the tax liability that may arise when he dies.

The company is currently well managed under the guidance of his son Larry. Harry plans on leaving the business to Larry, but is not yet ready to give him voting control. Harry asks you for suggestions.

In this situation, an estate freeze may be the answer. By implementing an estate freeze, Harry will be able to freeze all or part of the value of the growth assets (shares of Putter Inc.) at a fair market value (FMV) of $15 million, such that any future growth of these assets is shifted to the next generation (Larry). As a result, the future growth of Putter Inc. will not be taxed in the hands of Harry either during his lifetime or at death. Instead, the future growth of the business will only be taxed when Larry sells his shares or when Larry dies. Harry can also structure the estate freeze in such a way that Larry is not initially given full control over the management of the business.

Estate Freeze versus Other Methods of Transferring a Family Business

Let's compare the tax implications of the various methods available to transfer wealth from one generation to another.

1. Gifting of the Shares

If you gift the shares of the family corporation to your children, or transfer those shares to a trust for their benefit, the tax rules will deem you to have disposed of those shares at FMV and the recipients adjusted cost base (ACB) is deemed to be FMV. The result is that you may have to pay tax on the gains from those shares in the year you made the gift.

Note: If the shares are qualified small business corporation shares, it is possible to shelter gains under the $750,000 capital gains exemption (CGE). See below for a discussion of what qualifies as a qualified small business corporation.

In addition to the immediate capital gains tax liability, if the beneficiaries are minor children, then attribution rules stipulate that income earned on the assets be attributed back to the original owner of the asset. The main advantage of gifting is simplicity.

2. Sale at Less Than Fair Market Value

If you sell the shares to your children at less than FMV, your sale proceeds are deemed to occur at FMV. This can result in potential double taxation. The amount of tax you owe will be based on the FMV of the shares and not what you actually received. The “extra” tax you may end up paying does not become a benefit for your children since the calculation used to determine their future tax liability will be based on what they actually paid.

Selling shares (rather than gifting shares) to your children can also expose those shares to spousal and common-law partner claims in the event of a relationship breakdown in certain provinces. For example, in Ontario, shares that are sold to a child may be subject to an equalization claim on the marriage breakdown of a recipient child in the absence of a domestic contract which provides otherwise. In the case of a gift, the Ontario Family Law Act provides that a gift and any income derived from the gift may be exempt from an equalization claim by the spouse where the gift was made after the marriage of the child and was made subject to the express condition that the income derived from the gift would not be included in net family property. Since provincial laws may differ, check with your local authorities for the laws that may apply to your specific situation.

The main advantage of selling shares is that in addition to actual monetary consideration it may be possible to defer the recognition of some of the capital gain by using the reserve provisions in the Income Tax Act, if a promissory note is taken back as consideration for the sale.

Provided that 20% of the purchase price is paid annually the seller can spread the payment over a 5 year period and any capital gain can be recognized in the same proportion as the payments are received, for tax purposes.

3. Estate Freeze

If an estate freeze is used, the assets (the growth shares of the business corporation) are commonly transferred to a family trust while the business owner (the “freezor”) takes back “freeze shares” (i.e. shares which have no participation in the future growth of the business). Such a transaction can be accomplished on a tax deferred basis so that there will be no capital tax implications for the freezor until death. In essence, a growth asset is converted to a fixed income asset without immediate tax implication.

Benefits of an Estate Freeze

1. Managing the tax liability.
2. The freezor maintains control over the asset.
3. Crystallization of the CGE by the freezor.
4. Use of the CGE by other family members in the future.

Let’s look at each of these in greater detail:

1. Managing the Tax Liability

The primary purpose is to freeze all or part of the value of a growth asset at the current FMV, so that any future increase in the growth asset accrues to other individuals (usually the next generation of family members). As a result, the future growth of the asset will not be taxed in the hands of the freezor either during his or her lifetime or on death. By freezing the value of their interest in the company, the freezor’s future capital gains tax liability will be relatively predictable. Insurance solutions should be considered as a means of dealing with the frozen tax liability after an estate freeze has been affected.

2. Maintaining Control

Although the freezor may want to have the benefit of future growth on business assets accrue to his children, he may not be ready to relinquish control over the business yet. The estate freeze is often designed in such a way as to ensure that control over the direction of the business is, at least initially, retained by the freezor.

3. Crystallization of the Capital Gains Exemption by the Freezor

The CGE is available to shelter capital gains resulting from the disposition of shares of qualified small business corporations (QSBC). A QSBC is one that satisfies the following 3 basic tests:

- It is a Canadian-controlled private corporation (CCPC) that is using all or substantially all (this is generally considered to mean at least 90%) of its assets in carrying on an active business in Canada at the time of the sale;
- The shares have been owned by an individual or anyone related to such person for a continuous period of 24 months or more prior to the date of sale; and
- The company was a CCPC throughout the 24-month period prior to the date of sale, and had used at least 50% of its assets in carrying on an active business in Canada during that time.

4. Use of the CGE by other Family Members

Assuming that the CGE is still available at the time the next generation disposes of its shares, and that the QSBC tests are satisfied, there is the potential of multiple use of the CGE to shield gains from the sale of the business.

Many wealthy individuals operating businesses through a corporation many not be aware of the benefits of an estate freeze. If you wish to transfer the future growth of your business to family members without losing control of your business or having to pay immediate taxes, then you may want to consider an estate freeze.

An estate freeze can be a critical component of the business owner's business succession plan. As estate freezes are complicated transactions, professional advice should be obtained.

Revised 26/10/2011