Estate Freezes: What You Need to Know

What is an Estate Freeze?

An estate freeze is a sophisticated tax planning technique. It is used to stop the growth, either in whole or in part, of a client's estate. This planning technique appeals to older, wealthier individuals with estates large enough to transfer any increase in value of some or all of their assets to the next generation. It is done by replacing growth assets, such as equity shares or any other assets with growth potential, with non-growth assets such as cash, promissory notes or fixed value preferred shares.

Why Do It?

When an individual freezes the value of his/her estate, that individual will effectively lock in the tax liability that will arise on his/her death, subject to the tax rules in effect at that time. Consequently, an effective estate freeze will allow an individual to pre-determine the taxes that will arise upon his/her death so that the individual can make sure that cash will be available to pay the tax. Purchasing life insurance is one way to effectively guarantee that cash will be there when it is needed.

The Results

There are a number of possible outcomes from an estate freeze. The following is a partial list:

- Fix capital gains tax liability at today's level
- Pass asset growth to the children without immediate tax consequences
- Facilitate a share purchase by an employee or group of employees
- Ensure that a family business can remain a family business
- Multiplying access to the $500,000 small business capital gains exemption
- Crystallize gains for the $500,000 small business capital gains exemption
- Allow for orderly, systematic redemption of shares following retirement or in the event of death.
- Enable income splitting (note: beware of the attribution rules)
- Structure a stream of dividend income to a retiring shareholder

Estate Freeze Methods

There are many methods for accomplishing an estate freeze. The simplest is the **sale of assets** to an intended beneficiary. Another is the **sale of assets to a trust.**

Sale of assets refers to the sale of growth assets. The sale is for full consideration evidenced by a legally binding promissory note. The sale triggers a capital gain, with the vendor in certain circumstances being able to claim a reserve in respect of proceeds that are deferred to a later taxation year. Where such a reserve is claimed, it is still necessary to recognize at least 1/5th of the gain in the year of disposition and in each of the four subsequent years (subsection 40(1)).

In the case of certain farm property or shares of a small business corporation, a reserve may be available in certain situations, with there being a requirement to recognize at least 1/10th (subsection 40(1.1)).

Sale to a trust is used when minors are involved or when wanting to name the beneficiaries at a later date rather than at the time of the freeze. Also by means of the trust, the distribution of property may be postponed. In order for a freeze by a sale to a trust to be effective from an income tax point of view, the terms of the trust must be such that there can be no way in which the property may revert back to the transferor.

Corporate Estate Freezes*

There are several different methods under this category. The following is a partial list:

- Sale to a corporation
- Section 85 Rollover
- Section 84.1
- Reverse Freeze
- Section 86 Reorganization
- Section 51 Conversion

The following information will limit itself to the **section 85 rollover** and the **section 86 reorganization** methods.

**A detailed discussion of the above is beyond the scope of this document and should be done with the individual's legal and accounting advisors.*

Case Study

XYZ Company (XYZ Co) is 100% owned by Marc, a male age 55. He is considering an estate freeze in order to save on long-term taxes and to ensure an orderly transfer of business ownership to his children. In a discussion with his advisors he decides to keep 50% of his business and to transfer 25% each to his two adult children, who are working in the business. The present value of the company is $1,000,000 with an original cost base of $10,000. The following would happen using the **Section 85 Rollover** method.

Section 85 Rollover Method

Marc incorporates a holding company, Holdco, and issues 50% of the common shares to himself and 25% to each child.

He then transfers his common shares of XYZ Co. to Holdco in exchange for preferred shares. The value of the redeemable, retractable preferred shares is $1,000,000.

This is done without tax as long as the value of the Holdco preferred share is equal to the value of the common shares of XYZco. In addition, the adjusted cost base (ACB) of the preferred shares should be equal to the ACB of the XYZ Co common shares.

Marc arranges for the redemption value of the Holdco preferred shares to be $1,000,000 and the ACB to be $10,000. This gives Marc a capital gain of $990,000 to which he can apply the $500,000 small business capital gains exemption.

His preferred shares in Holdco are fixed in value, since Holdco can redeem them at any time for the $1,000,000 (they are redeemable) and Marc could demand they be redeemed for $1,000,000(they are retractable).

Consequently, any future increase in the value of XYZ Co, which is owned 100% by Holdco, will be reflected in the common shares of Holdco.

Example

Duration	Assumed of XYZ Co	Value of Holdco	Value of Holdco commons
5yrs	1,250,000	1,000,000	$250,000
10 yrs	1,500,000	1,000,000	$500,000
15yrs	5,000,000	1,000,000	$4,000,000

In this example, the value of the Holdco commons will be divided equally among Marc and his two children, but the share structure of Holdco could have been arranged at the outset to provide any other ownership proportion. If Marc had decided to do a 100% freeze passing all growth to the children, then his interest would remain at $1,000,000 throughout and the XYX Co common shares would belong solely to the children.

From a tax perspective alone, a 100% freeze can be attractive. Also, if Marc and his wife use a spousal rollover to defer tax until the second to die, then the tax numbers shown above could be deferred.

When implementing a “Section 85 rollover” it is important to remember that Marc no longer owns XYZ Co directly. He and his children own Holdco, which in turn owns XYZ Co. Any sale of shares hoping to benefit from the Small Business Gains Exemption treatment would have to be a sale of Holdco share. It would be important to keep Holdco “clean” with less than 10% of the FMV invested in investment funds or properties.

Section 86 Method

Rather than create a new company for the purposes of a freeze, Marc could decide to simply re-organize the shares of XYZco. He would return all his shares to XYZ Co, and receive preferred shares with the same value in exchange. XYZ Co would then issue new common shares for nominal consideration.

In all major respects the rollover treatment is the same as for a **section 85 rollover**, without the use of a second corporation.

Where there are no other shareholders, and where no long-term investment diversification objectives are in sight, a Section 86 re-organization can be somewhat simpler and more direct. As long as the children who receive common shares are not minors, there should be no application of the attribution rules.

Points to Consider

1) If a shareholder completes a freeze by giving shares to children, the children actually own the shares. As shareholders, the children should be parties to a shareholder agreement.
2) If a discretionary trust is used to hold shares for future distribution to the children, then the parents/trustees have up to 21 years to decide who should become a shareholder.
3) The divorce, death, bankruptcy, or incapacity of a child might cause a triggering event under a shareholder agreement, but would have no structural or tax impact if the shares were held in a discretionary trust.
4) An estate freeze can fix the amount of capital gains tax. Generally, it does not make the tax go away, nor does it provide the means to pay the tax. Life insurance can and should be an integral part of the planning process.
5) Involving all children equally as shareholders is not necessarily an equitable solution. The survival needs of the business must be balanced with need for equality among children.
6) An estate freeze is not a business succession plan, but rather a part of the plan. It has to be consistent with the original objectives of the founding shareholder or shareholders.

What Happens Without An Estate Freeze?

It must be remembered that as a company experiences growth in its share value its tax liability grows also.

There are also **missed opportunities** such as:

- Make it possible to income split with the spouse and children.
- Provide an inheritance for the family.
- Create a future income stream through the use of dividends.
- Multiply the capital gains exemption.
- Create a legacy that would remain in the family.