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Estate Freezes — The Basics

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What is an Estate Freeze?

An estate freeze refers to the transfer of the future growth in value of a business, investments, or other assets into the hands of subsequent generations (the "children"). The current owners (the "parents") are effectively divested of this future growth. An estate freeze typically limits the value of the parents' estate to the value at the date the freeze is implemented (the freezor typically retains the current value of the asset, 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 parents to children are avoided.

Why is an Estate Freeze Implemented?

The main reason to implement a freeze is to maximize the value of the estate that will ultimately pass to the freezor's beneficiaries. The avoidance of capital gains and other tax that would otherwise be incurred on the transfer of appreciated assets to a subsequent generation means that the beneficiaries will receive more (and the CRA less). An individual is generally considered to dispose of his or her capital property on death at fair market values. Reducing the value of one's property that will be subject to these "deemed disposition" rules serves to maximize the value of the assets received by the beneficiaries. For this reason, an estate freeze is implemented when the assets of the freezor are expected to appreciate.

In addition to avoiding capital gains tax upon the death of the parents, an estate freeze may serve a number of other purposes.

Asset Protection

It may be possible to afford a degree of asset protection with respect to shares held by the children (or better still by a discretionary family trust in their favour). Shares held by the parents might be subject to claims as a result of personal guarantees, judgment creditors, etc. Depending on the circumstances and the structure of the estate freeze, this may not be the case with respect to shares held by the children.

Probate Planning

Because an estate freeze limits the future growth of assets, it also limits the value of the freezor's estate at death — probate tax being imposed in accordance with the magnitude of the latter. Probate tax is highest in Ontario and British Columbia and, in these provinces, probate planning has become an integral part of estate planning. It should be noted, however, that probate fees can be reduced significantly through the use of multiple wills as well as alter ego and joint partner trusts, where, among other things, the entire value of a private corporation can avoid probate.

Marital considerations

In addition to limiting the future growth of assets with respect to the parents, an estate freeze will often be designed to limit marital claims with respect to the growth assets.

Incorporation tax benefits

The tax benefits of incorporation may also be obtained or enhanced by implementing an estate freeze. This may include creating a second small-business base, i.e., by creating a new corporation to be frozen that is not associated with a pre-existing operating company.

How is an Estate Freeze Implemented?

In its most basic form, an estate freeze is simply the transfer of appreciating assets to a subsequent generation. It can be as simple as transferring ownership of an asset (by sale or gift) to a child or grandchild. Although this will achieve the objective of shifting capital gains tax liability from one generation to the other, such simple transfers may involve immediate tax exposure because of the deemed disposition rules. Further, a straightforward transfer may undermine the desire of the parents to maintain a degree of control over the assets.

For these reasons, the most common form of estate freeze involves the transfer of assets to a corporation or the reorganization of an existing corporation, often combined with a family trust. The corporate vehicle usually permits the implementation of the estate freeze on a tax-deferred basis. Furthermore, corporate equity structures allow economic and legal rights in respect of the underlying property to be specifically defined and carved out. The trust affords additional degrees of control and protection against mismanagement by the beneficiaries and may enable the trustees to actually determine which beneficiaries will ultimately receive the trust property.

Basic Configuration of an Estate Freeze

Achieving the basic objectives of estate freezing with respect to an incorporated business usually involves a corporate reorganization such that the parents have shares with either limited or no participation in the future growth of the corporation. The children have shares that carry rights to future appreciation, and in many cases income-splitting advantages, notably the ability to distribute dividends such that they are taxed in the hands of the children.

This structure can be achieved in a number of ways, including the transfer of personally held assets to be frozen into a corporation, i.e., in consideration for freeze shares, with common shares representing the future growth of the corporation.

Where the assets to be frozen are already held by a corporation, the structure can be achieved through an "internal freeze", where the pre-existing shares are converted into freeze shares, with common shares representing the future growth of the corporation.

"Growth Shares"

In a simple freeze structure, the children would receive equity or growth shares (i.e., shares that would contain the rights to residual equity growth and dividend participation after the rights of the parents' shares were satisfied). Since the existing value of the corporation would typically be reflected in the parent's frozen shares, the growth shares would initially have almost no value. In most cases, the growth shares will simply be ordinary common shares.

In many cases, a freeze involves the use of a holding company, which would hold the shares of the operating company. One key advantage of a holding company is that the operating company could distribute dividends thereto so as to limit the operating company's exposure to creditors.

Family Trust

It is very common for the growth shares to be held by a family trust rather than the children themselves. The purpose of the trust is to afford a degree of control and protection against mismanagement and, often, to provide flexibility in determination who inevitably gets the shares.

Trusts are vehicles through which property is managed and administered for the benefit of the trusts' beneficiaries. Trusts are established for tax and non-tax reasons. Some non-tax reasons for the establishment of trusts include providing individuals with the benefit of property ownership where they are unable to manage the property personally. Trusts are implemented for beneficiaries who lack business experience or knowledge, for infants, mentally disabled and incompetent persons who lack the capacity to manage their affairs, and for those persons who are not legally incompetent but merely lack judgment. Some tax reasons for the establishment of trusts include the saving of income tax through income splitting and the deferral of income tax on capital gains. However, such tax benefits can be achieved without the interposition of a trust, i.e., the tax planning arrangements could be made directly with family members. Even though trusts may, in a sense, be tax motivated, in another sense, it is the protective element that usually dictates the interposition of a trust.

However, trusts are a particularly effective tool in estate and business succession planning, and estate freezes in particular. They are a means by which an owner-manager can slowly ease into various succession phases. Trusts are predominantly used in the estate planning area to allow individuals to transfer assets to family members (or others), while maintaining some form of control over the transferred assets. In a direct and outright transfer to such persons (as opposed to a trust), the transferees acquire full title to the assets and the transferor may relinquish all control over the assets. The use of a trust allows for a degree of flexibility as to whom the transferor may want to give eventual control of the business if she or he so chooses. Through the use of a trust, the transferor retains some control, as a trustee of the trust or by choosing the trustees, and by dictating the terms of the trust.

Accordingly, the typical estate freeze would normally use a trust so that any future accrued gain is passed on to the trust, for the benefit of the children/issue. The same result could be obtained were the growth shares transferred directly without the use of a trust to the spouse and children, but, in such a case, the transferor would have to decide immediately as to the percentage of ownership to go to each child. The use of a trust allows the transferor to maintain control and flexibility, while at the same time setting up the scenario for the eventual succession of the business to the next generation.

When Should a Freeze be Implemented?

Before a professional recommends that you carry out an estate freeze, they will review all of the relevant facts and circumstances. A freeze will not always be advantageous.

Non-Tax considerations

Here are some of the more common non-tax considerations when contemplating an estate freeze.

1. **Inflation**: It is important to ensure that the effects of inflation do not leave parents without sufficient assets to meet their personal needs.
2. **Personal Issues**: The psychological (not to mention legal) effects of estate freezing should be considered carefully, as the outcome may be to place substantial assets in the hands of the children. These effects should be considered carefully, from the point of view of both the parents and the children.
3. **Family Law**: Family law and asset protection concerns should be addressed. For example, a parent may be apprehensive to provide growth shares to a married child if there's a possibility that the business wealth may end up in the ends of the child's spouse should they later separate.
4. **Other Asset Protection Issues**: Shares held by parents could be subject to claims as a result of personal guarantees, judgment creditors, etc. Depending on the circumstances and the structure of the estate freeze, a degree of asset protection may be possible with respect to shares held by children, with even greater protection if the shares are held by a discretionary family trust.
5. **Holding Period After Death**: If the assets to be frozen are likely to be sold after the death of the parents, there may not be too much point in an estate freeze, since the children will have to pay tax on the sale of the assets in any event.

Tax considerations

The following are some tax considerations relevant to whether a freeze should be implemented:

1. **Double Tax**: Where an estate freeze involves the transfer of assets from an individual to a corporation (or a partnership, for that matter), it should be noted that there is the potential for double tax, especially on death.

Because the corporation is a separate taxpayer, the deemed or actual disposition of the shares of the corporation and the underlying assets that give the shares their value, may result in tax complications because of the potential for double taxation — i.e., once on the actual or deemed disposition of shares, and a second time when the underlying assets themselves are sold. Mechanisms are available to avoid the double taxation resultant from the deemed disposition on the death of a shareholder; however, these procedures are complex and come with time constraints and costs. It might be best to avoid having to resort to them if possible.

2. **Capital Gains Exemption**: Also consider whether the capital gains exemption would be available to shelter tax exposure when shares eventually pass from the parents to the children. Attention must be paid to matters such as the asset composition and thereby the eligibility for the exemption. It may be possible to put structures in place that may multiply entitlement to the capital gains exemption among family members, e.g., using a family trust to hold growth shares so that the structure is consistent with a conventional freeze. However, this will usually involve a "purification structure" whereby non-qualifying assets can be systematically removed from the corporation so that its shares will continually qualify for the capital gains exemption.

3. **Tax on Split Income**: The tax on split income ("TOSI") used to be applicable to children under the age of 18, but now it applies to all family members, regardless of age. Where an adult child receives a dividend from the growth shares or realizes a capital gain from disposing of those shares, that income could be subject to the TOSI, and thus the child is liable for a punitive amount of tax. There are many exceptions from TOSI, but it requires careful consideration of whether it will apply given the circumstances. Simply put, TOSI is a crucial consideration when structuring an estate freeze, because it can result in negative tax consequences. The freeze might also be structured in a way that will avoid the application of TOSI altogether. For an overview of TOSI and the many exceptions from its application, see the previous quarterly corporate tax newsletter.