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REFERENCE GUIDE

WEALTH PLANNING GROUP

ESTATE FREEZES

The estate freeze is a strategy used by many Canadian business owners to help accomplish estate-planning, business succession and asset protection objectives.

This reference guide provides a general introduction to estate freezes, outlines the potential benefits and disadvantages associated with these transactions and reviews implementation and structuring considerations.

Introduction

As a business owner, once you have accumulated the level of wealth sufficient to allow you to live your desired lifestyle well into your retirement years, an estate freeze may provide you with the benefit of reduced tax while creating flexibility for you and your family in terms of succession of wealth to the next generation.

An estate freeze would generally involve your corporation, and would allow you to set, or freeze, the value of your business interests at their current value by exchanging the growth common shares of your corporation for preference shares having a fixed value (sometimes referred to as freeze shares). You would then determine who would benefit from post-freeze growth by deciding who will receive new growth common shares, usually referred to as the freeze beneficiaries.

Your decision would usually be based on a number of factors, including the relative financial position of the persons involved, your objectives for implementing the freeze, tax and family law considerations. If done correctly, income tax may be reduced and deferred to future years.

It is important when deciding who should ultimately benefit from receiving new growth common shares to include your tax professional in the conversation to avoid triggering unexpected adverse tax consequences as discussed later in this guide.

Implementation

WHEN SHOULD I CONSIDER IMPLEMENTING AN ESTATE FREEZE?

Determining when to implement an estate freeze requires consideration of your financial position as well as your estate-planning and business succession objectives.

You would generally use an estate freeze to cap the value of your business interests once you have reached a comfortable level of personal wealth and, perhaps, a certain age. The decision would depend on your profit projections and family situation, together with the relative income levels of your family members and other tax considerations noted in this guide.

Market forces and valuation considerations can also affect the determination of when to implement an estate freeze. If your objective is to minimize income and probate taxes, timing an estate freeze to occur when your business' value is depressed could result in additional growth being passed along to the beneficiaries of the freeze, further minimizing your exposure to taxes on death.

WILL I TRIGGER TAX CONSEQUENCES WHEN IMPLEMENTING AN ESTATE FREEZE?

Tax consequences of the estate freeze

Estate freezes are routinely structured to comply with special income tax rules thereby allowing business owners who implement properly structured estate freezes to avoid triggering immediate income tax consequences. Tax that would otherwise immediately apply is not eliminated but instead deferred until a future point in time; such as the next disposition of the property. This is generally referred to as occurring on a tax-deferred basis.

The CRA has established administrative guidelines that must also be satisfied in order for an estate freeze to occur on a tax-deferred basis. In particular, the CRA requires that freeze shares have the following rights and attributes:

- Freeze shares must be retractable. This means that they must be redeemable at the option of the shareholder.
- Freeze shares must have a priority right to receive assets when the corporation is dissolved or wound-up.
- Freeze shares must be transferable without restriction, except for those imposed under corporate law.
- Freeze shares must have sufficient voting rights to protect against changes to the rights and attributes listed above.
- The corporation must be restricted from paying dividends on other classes of shares that will impair the corporation's ability to redeem the freeze shares.

Your professional tax advisor should always be consulted in conjunction with your corporate legal advisor when authorizing a class of shares to be used to facilitate an estate freeze.

Other tax consequences

An estate freeze is usually undertaken as a means of satisfying other objectives or generating other benefits for you and/or your family members. Such benefits are summarized below along with some key tax considerations that should be considered as a part of the planning phase.

CAN I REVERSE AN ESTATE FREEZE?

Implementing an estate freeze should generally be considered permanent and, as a result, should only proceed following careful consideration. That being said, there are certain planning measures that can help alleviate unanticipated future difficulties and which may allow for an estate freeze structure to be reversed or thawed, if proper advance planning is undertaken.

These situations include:

- unanticipated cash flow constraints arise in retirement
- conflicts develop with freeze beneficiaries
- other unanticipated post-freeze changes in family or financial situations occur
- misunderstandings exist as to the legal nature of the estate freeze (i.e. that the right to future growth was legally transferred to the freeze beneficiaries), and
- the value of the corporation has decreased and the value of the freeze shares is no longer reflected in the corporation's current fair market value, which on death could have significant tax implications.

If one or more of these situations arise, you should immediately consult your professional tax advisor to explore your available options, as well to ensure nothing is undertaken that may expose you or your corporation to unintended adverse tax consequences.

Benefits

The specific benefits that you will derive from implementing an estate freeze depend on a number of factors but generally include:

- minimizing income and probate taxes on death;
- facilitating capital gains exemption planning;
- facilitating business succession;
- allowing control following retirement; and
- creating income splitting opportunities.

MINIMIZING INCOME AND PROBATE TAXES ON DEATH

Minimizing income tax

Unlike many other countries, Canada does not levy death taxes, per se. Nevertheless, Canadians may face significant income tax consequences when they die, due to tax rules that deem them, as individuals, to dispose of their assets immediately before death.[1] These rules generally result in

[1] The dispositions are deemed to occur at fair market value except, most notably, where a deceased person transfers his or her capital property to a spouse (or to a qualifying spousal trust). In these situations, the deemed disposition at fair market value will not apply and tax is deferred until the death of the surviving spouse (or until the spouse or spousal trust otherwise disposes of the property).

the recognition and taxation, on death, of capital gains that have accrued throughout your lifetime.[2]

Since these rules apply to untaxed growth in the value of private corporation shares, successful business owners require careful estate planning in order to avoid substantial taxation on death. Estate freeze transactions are often employed to help manage this potential tax liability.

As described above, estate freezes transfer future growth to other freeze beneficiaries. This results in a transfer of the responsibility to pay tax on that growth to the freeze beneficiaries, creating a tax deferral. Instead of the tax liability being triggered on your death, it is delayed until the freeze beneficiaries die or otherwise dispose of the shares. In the classic estate freeze scenario where next generation family members are named as the freeze beneficiaries, tax can be deferred over a potentially significant period of time.

Deferring tax is valuable since it is generally better to pay taxes later rather than sooner, particularly where lower income tax rates are anticipated in the future. The deferral value of an estate freeze includes both minimizing your date-of-death tax liability and increasing the net wealth of your estate freeze beneficiaries.

Minimizing probate tax

Estate freezes can also limit exposure to probate fees, which are a provincial tax imposed by the courts during the processing of wills. Probate fees are usually applied according to an estate's value: as the value of an estate increases, so do applicable probate fees. Implementing an estate freeze to fix the value of your corporate interests limits exposure to future probate fees in the same way that it minimizes exposure to income tax on death - by preventing future growth from accruing to you.

Note, more generally, that undertaking an estate freeze helps identify and quantify income taxes and probate fees that will likely arise on death. Once determined, you can plan how best to deal with these liabilities within an overall estate plan, which might involve systematically redeeming your freeze shares, implementing life insurance strategies, alternative will arrangements. and other solutions.

FACILITATING CAPITAL GAINS EXEMPTION PLANNING

The capital gains exemption can be used by individuals to shelter them from tax arising from up to $913,630[3] of capital gains realized on the sale (or deemed sale on death) of qualifying small business corporation (QSBC) shares.[4] Using the capital gains exemption is a key estate-planning objective for business owners and estate freezes are often used as a component of such planning.

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[2] This date-of-death tax liability can be mitigated where property qualifies for the capital gains exemption.
[3] Indexed annually for inflation
[4] To meet the QSBC definition, shares must satisfy various tests, including regarding the proportion of the corporation's assets that are active business-use assets versus passive non-business use assets. Details are further discussed in our reference guide on tax planning for the sale of your business.

For example, implementing an estate freeze can allow you to access the separate QSBC share exemptions of other family members. This can result in significant planning opportunities if, in the future, you are contemplating selling qualifying shares for proceeds that will exceed your personal capital gains exemption limit.

Depending on your circumstances, you might also consider crystallizing your QSBC share exemption as part of an estate freeze transaction, if your shares currently qualify as QSBC shares but you are concerned that they will not, going forward. If properly implemented, a crystallization transaction steps-up the cost base of your shares (to the extent elected) on a tax-free basis.

Strict technical requirements must be met in order for the QSBC share exemption to apply. Unanticipated negative tax consequences can arise if careful planning is not undertaken, particularly in non-arm's length share sale transactions. If, in the future, you are considering claiming the exemption in connection with your private corporation shares, you should consult with your professional tax advisors well in advance to ensure that all technical requirements are satisfied.

FACILITATING BUSINESS SUCCESSION

As retirement approaches, owners start planning for business succession. In some cases, children will step-in to carry on the business, while in others they will not. Alternatively, some children, but not all, will become involved.

Estate freezes are often used to facilitate transfers of business operations to the next generation. For example, if you wish to limit the financial barriers that your child or children might face to enter the family business, an estate freeze might be appropriate as it could facilitate new family members becoming equity participants at nominal subscription prices. Incorporating trusts into an estate freeze can permit succession objectives to be met as they develop over time and provide maximum flexibility to business succession planning, due to their inherent flexibility.

ALLOWING CONTROL FOLLOWING RETIREMENT

Many business owners reach a stage where they are ready to step away from actively running their business but are averse to relinquishing control due to emotional and/or financial ties. For some, maintaining control offers peace of mind where questions exist as to the business acumen of family members taking over the business. Estate freezes can be structured to allow you to back away from daily business operations while retaining a desired level of control.

One method of doing so is to issue control shares (voting preferred shares) to yourself as part of an estate freeze. This will not impair the objective of passing future growth entitlement to freeze beneficiaries, yet it satisfies the objective of not foregoing ultimate control over your business operations[5]. Control shares are typically issued for nominal value. It is generally recommended

[5] You should discuss how voting control may impact the corporation's ability to pay dividends to all shareholders in lights of the tax on split income (TOSI) legislation.

that they form a different class of shares than the freeze shares, which separates your voting rights and equity value, creating added flexibility for future planning.

Implementing an estate freeze does not preclude you from continuing as a director and/or officer of a corporation, which can serve as another method of maintaining a voice in the direction and/or management of the business following retirement from active duty.

CREATING INCOME SPLITTING OPPORTUNITIES

Splitting income by using family members' lower marginal brackets may be a way of reducing tax applicable to a family unit and, under strict guidance, may still be an objective of a robust estate plan. However, the tax on split income(TOSI) rules make it extremely difficult to effectively split income with family members going forward.

Legislation introduced by the Federal government as a part of the 2018 budget curbed the ability of Canadians to split income by expanding the rules thus leaving only the narrowest opportunities available. Refer to the TOSI summary below for more details.

Other important tax considerations

TAX ON SPLIT INCOME (TOSI)

The Canadian tax system is one that is based on the income of the individual, not the family unit as a whole. A family with one individual earning $100,000 of income will pay more tax than two individuals earning $50,000 of income. Income splitting has been used to shift income from one taxpayer in a higher tax bracket to one or more family members in a lower tax bracket, thus resulting in less overall tax otherwise payable on that income.

In order to prevent families from income splitting, the Federal government significantly expanded the TOSI legislation to include more sources of income, as well more family members. The rules are essentially designed to dissuade you from paying dividends or capital gains to other family members. Note that while they don't prevent you from paying dividends or capital gains, doing so will result in severely adverse tax consequences.

Under the legislation, income caught by the TOSI rules is taxed at the highest marginal tax rate for that particular individual unless a specific exemption within the legislation specifically applies to that individual. The rules are complex, and a thorough understanding of the pertinent facts for each situation must be reviewed in conjunction with the legislation before any conclusions can be reached.

Refer to our TOSI reference guide for more details but ensure to speak with your professional tax advisors prior to undertaking any income splitting measures, or when planning for an estate freeze in general.

ATTRIBUTION RULES

The purpose of the attribution rules is to prevent individuals from splitting income and capital gains with their spouses, and parents from splitting income with their minor children. There are generally two main types of attribution to be cognizant of when undertaking estate planning:

Personal attribution

These rules can apply when you transfer or loan property to a spouse or to a relative under the age of 18 either directly or through a trust. If applicable, income and/or capital gains from the assets are attributed back to you for tax purposes, preventing income splitting.

Corporate attribution

Corporate attribution can apply when property is transferred or loaned to a corporation for the benefit of a spouse or minor relative. If applicable, the rule deems you to receive an annual income inclusion based on the prescribed rate of interest[6].

Corporate attribution can sometimes be avoided, most notably where your corporation satisfies the small business corporation (SBC) definition. This requires (among other things) that all or substantially all[7] of the corporation's assets are used in an active business in Canada. Corporate attribution could still apply if your corporation fails to meet the SBC definition at any time following an estate freeze.

Another way to avoid corporate attribution, if using a family trust, is to ensure that the trust restricts your spouse and any related person, niece or nephew under the age of 18 from being entitled to receive any trust income or capital during your lifetime.

Complex considerations are involved when structuring an estate freeze to avoid the attribution rules, for which professional tax advice is required.

Disadvantages

Some potential disadvantages must also be considered when determining whether an estate freeze is appropriate for you.

For example, professional costs will be incurred, both at implementation time and annually to meet tax-reporting obligations. The fees will generally vary depending on the complexity of your business affairs and current organizational structure. Prior to proceeding, your professional tax advisors should provide you with an outline of the costs that you can reasonably expect to incur.

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[6] As set under the Regulations of the *Income Tax Act* (Canada).

[7] The Canada Revenue Agency (CRA) interprets this to mean 90%, although the Courts have held that in certain situations it may be less. Please see our reference guide on tax planning for the sale of your business for a detailed discussion of the SBC definition.

There is also a frequent concern that implementing an estate freeze poses a risk to your future financial sufficiency. Careful planning is necessary to protect against undertaking a freeze transaction too early before you reach a sufficient level of wealth. As well, consideration should be given to the range of pre-implementation strategies that can facilitate a freeze being reversed in the future, if necessary (see the related discussion above entitled *Can I reverse an estate freeze?*).

Loss of control over business operations is also a common objection to proceeding with an estate freeze. As described earlier, some options exist to mitigate the amount of control that you will forego by freezing your business interests, which can help alleviate this concern.

Conclusion

An estate freeze may provide significant tax and non-tax benefits for you and your family members if, for example, you have achieved a sufficient level of wealth to live in your chosen lifestyle throughout the balance of your lifetime. However, the tax benefits that might be achieved must be considered together with the potential consequences to your business operations, your personal financial sufficiency and your estate planning and business succession objectives.

The preceding discussion is intended to outline many of the points that you should canvass with your professional advisors when reviewing the possibility of an estate freeze.

For more information, we encourage you to speak to your advisor or visit us at assante.com

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Published June 7, 2022.