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April 2020

Estate Freeze

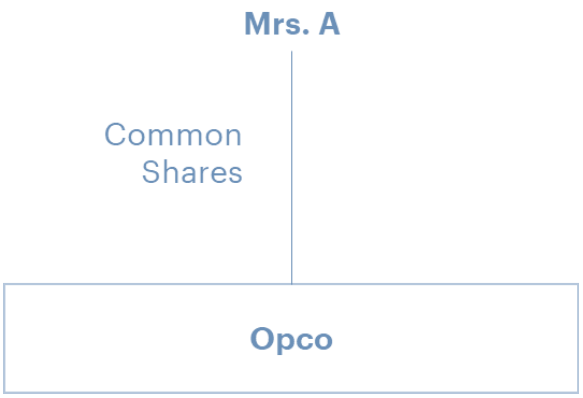
The economic issues associated with the COVID-19 pandemic may have significantly affected the value of your private corporation. While the financial impact may last for some time, you may have positioned your business to recover its value in the longer-term. If so, this could be the opportune time from a tax planning perspective to consider implementing an estate freeze.

WHAT IS AN ESTATE FREEZE?

An estate freeze is a strategy that allows you to freeze your economic interest in an asset at its current value and transfer all future growth to other parties. It can be especially effective if you believe the value of your private corporation shares will appreciate over time and you have other parties to whom you are potentially interested in transferring future value.

TRADITIONAL OWNERSHIP STRUCTURE

It is not uncommon when starting a business that the founder owns all of the shares of the corporation. As the company evolves, you should consider whether the ownership structure should be altered to capitalize on various tax planning opportunities and other succession-related objectives.



There are three potential disadvantages to the traditional ownership structure:

1. Income Sprinkling – In order to take advantage of the potential lower marginal tax rates of family members, you may want to provide them remuneration from the corporation. The Income Tax Act ("the Act") has long-standing rules in place in regard to the ability to pay reasonable salaries to family members, which can limit the ability to sprinkle income.

   Another alternative is for the company to declare dividends. However, if you are the sole shareholder of the business, you are the only individual who is entitled to receive dividends from the corporation. While the new tax on split income rules introduced in 2017 have limited the ability to sprinkle income using dividends, family members who own shares, either directly or indirectly, may still be able to take advantage of the opportunity if certain conditions in the Act are satisfied.

2. Capital Gains Exemption – There is a provision in the Act that allows an individual to shelter the first \$883,384[1] of capital gains realized on the disposition of Qualified Small Business Corporation ("QSBC") shares, which are essentially Canadian Controlled Private Corporations that have all or substantially all (i.e., interpreted by the Canada Revenue Agency ("CRA") to mean 90%) of the fair market value of their assets used in an active business carried on in Canada.

   If you are the only shareholder, only your capital gains exemption could potentially be claimed on a sale of the business. However, if members of your family held shares in the corporation, directly or indirectly, they could potentially use their capital gains exemptions on a share sale. This multiplication of the capital gains exemption would significantly reduce the family's overall tax burden; assuming the highest personal marginal tax rate is 50%, claiming the full amount of the exemption would provide a tax savings of approximately \$221,000 for each shareholder.

   Please refer to our article "Lifetime Capital Gains Exemption" for additional information on the capital gains exemption.

[1] The amount is indexed to inflation and adjusts annually. For qualified farming or fishing corporations, the capital gains exemption amount is \$1,000,000.

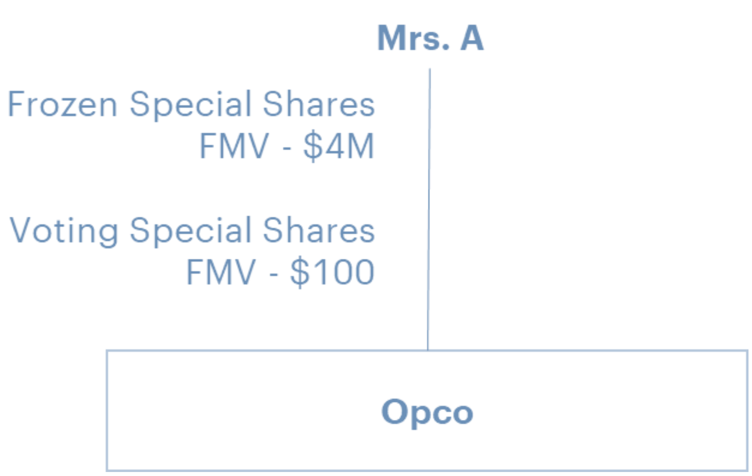
3. Deemed Disposition at Death – For Canadian tax purposes, when an individual dies they are deemed to have disposed of all of their capital property, including shares of private corporations, immediately before death at fair market value. There is an exception for property that is transferred to a surviving spouse or common-law partner, which effectively results in a deferral of this tax until the surviving spouse/partner sells the asset or dies.

   If you own all of the shares of the corporation, the entire value of the business will be subject to tax on the last-to-die of you and your spouse/partner. In the situation where there are other shareholders in the business, only the value of your shares will be subject to tax and the residual value will be deferred until the other shareholders sell their shares or die.

THE SOLUTION

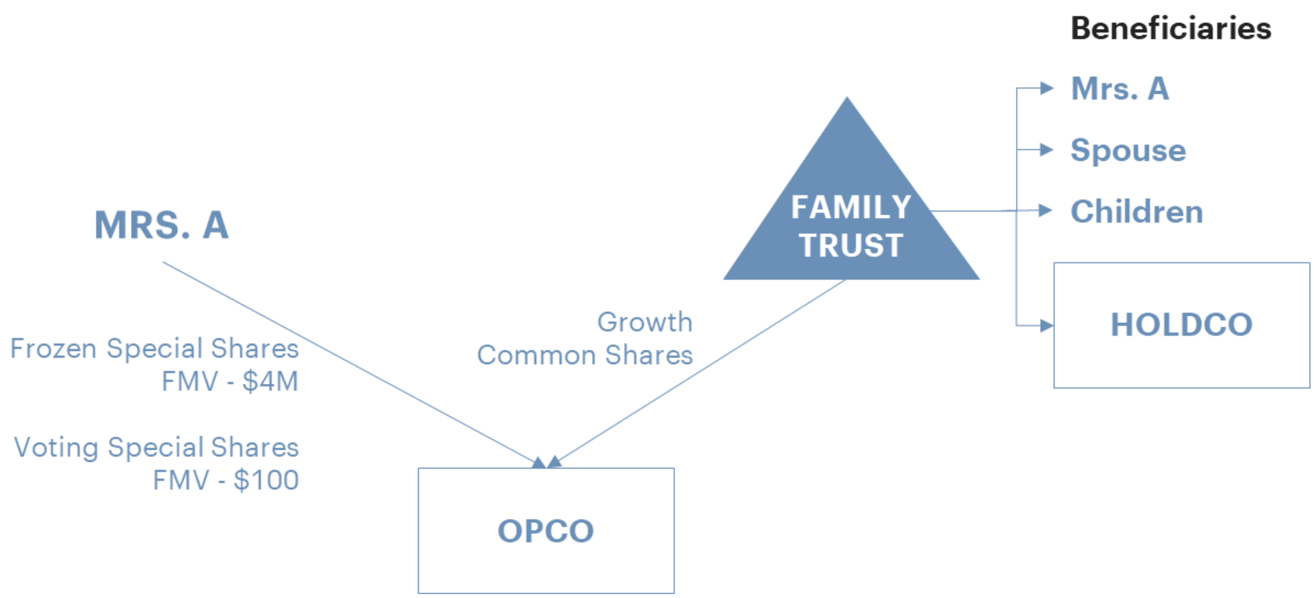
The remainder of this article is based on the assumption that the founding shareholder and any potential shareholders contemplated in the future are Canadian citizens and residents of Canada for tax purposes. The presence of US persons can impact, and even negate, this type of planning.

Getting shares into the hands of family members is not as easy as simply transferring your shares over to them, as this would result in a taxable disposition. Fortunately, an estate freeze strategy is able to facilitate this transaction on a tax-deferred basis.



Generally speaking, an estate freeze modifies a company's corporate structure such that the existing shareholder would exchange their appreciating common shares for a new class of special shares with no appreciation value, on a tax deferred basis. The special shares received would have a stated value equal to the current fair market value of the company. Regardless of what happens to the underlying business, the value of the special shares will not change (i.e., the special shares are "frozen" in value).

While you may be comfortable transferring the future growth of the company to the new common shareholders, you may want to retain voting control over the corporation. To that end, it is advisable that you consider authorizing and subscribing for a newly created class of voting control shares with a nominal stated value to ensure that you retain voting control of the corporation.

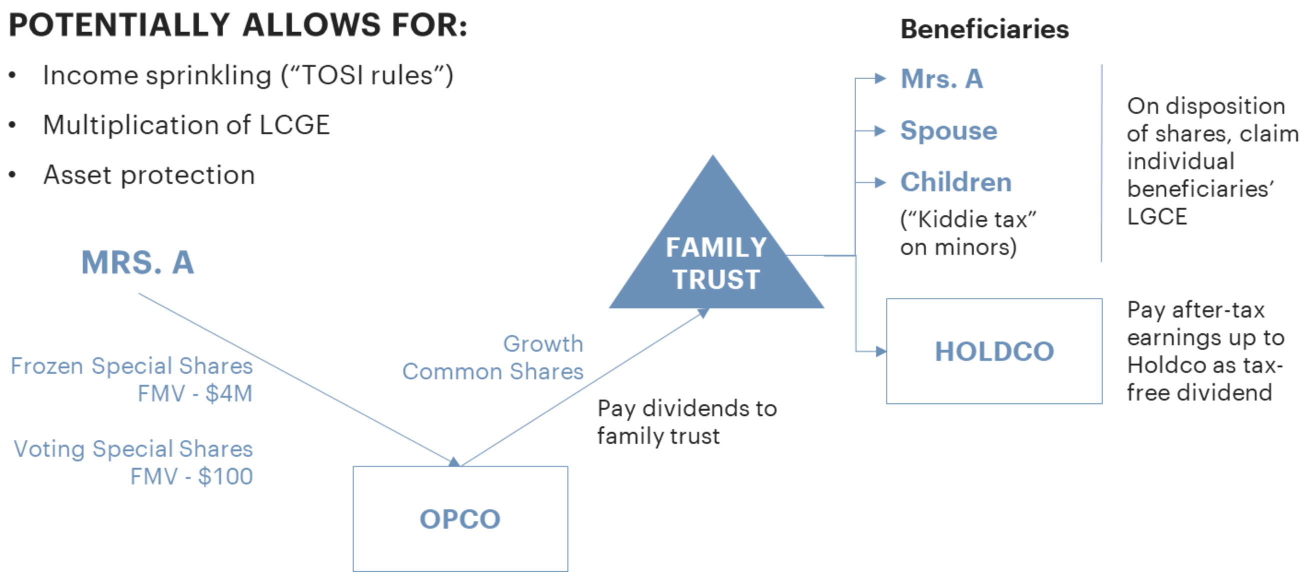


With the current value of the company now isolated in the special shares, the corporation can issue new common shares for a nominal amount. These new common shares are referred to as "growth shares", as any future increase in the value of the company would now accrue to the new common shares.

When implementing a freeze, you should consider who should own the growth shares. One option is to have the common shares issued to the individuals directly. However, this may not be possible based on their ages or financial expertise. In addition, you may not necessarily know today who should own the shares (for example, some or all of your children may still be in school and have not expressed an interest in joining the business).

To provide you with the most flexibility, from a planning, tax and control perspective, you may want to hold the growth shares in a discretionary family trust. With proper planning, you could be one of the trustees who controls the family trust. In addition, you could also be a beneficiary of the family trust which would allow you to participate in any future growth of the business.

Other beneficiaries of the trust could include family members, friends and/or other individuals that you wish to participate in any future growth of the business. It is also recommended that you provide for corporations owned by any of the named individuals as potential beneficiaries of the trust.



With growth shares now owned by the family trust, it may be possible to sprinkle income by declaring and paying dividends on the operating company's common shares. Provided that the tax on split income rules permit it, the dividend income could be allocated to individual beneficiaries and the income would be taxed in their hands at a lower tax rate. Alternatively, the family trust could allocate the dividend income to a corporate beneficiary, which could potentially receive the dividend on a tax-free basis.

MULTIPLYING THE CAPITAL GAINS EXEMPTION

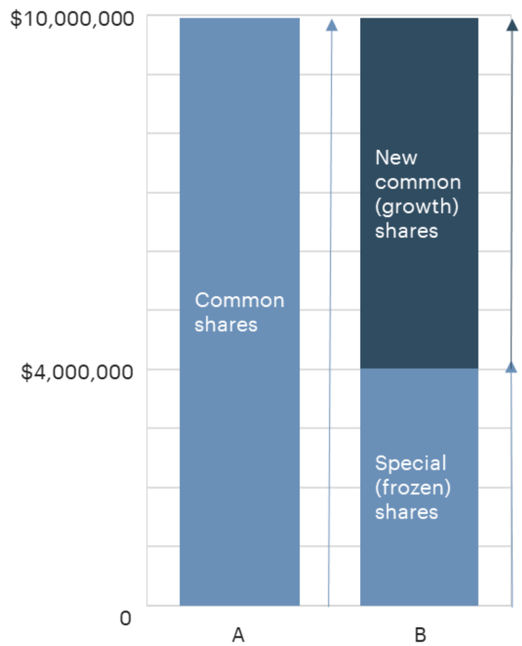
Assuming that the growth shares owned by the family trust increase in value over time, there is the potential to multiply the capital gains exemption on a sale of the business. When the family trust sells its shares, the trustees may exercise their discretion to allocate some or all of the realized capital gain to the individual beneficiaries to utilize each of their capital gains exemptions (provided the corporation satisfies the requisite conditions, as discussed previously). This flexibility afforded by the family trust would allow the beneficiaries to shelter from tax all, or a portion of, the allocated capital gains, thereby reducing the overall tax liability for your household compared to the traditional ownership structure.

SCENARIO A – SALE OF BUSINESS WITHOUT FREEZE:

	Common shares
Proceeds	$10,000,000
Cost Base	Nil
	$10,000,000
Owner's LCGE	(883,384)
Capital Gain	$9,116,616
Tax on Gain (@25%)	**$2,279,154**

SCENARIO B – SALE OF BUSINESS WITH FREEZE:

	Frozen Shares	Growth Shares
Proceeds	$4,000,000	$6,000,000
Cost Base	Nil	Nil
	$4,000,000	**$6,000,000**
LCGE (assume 4 individual trust beneficiaries)	(883,384)	$3,533,536
Capital Gain	**$3,116,616**	**$2,466,464**
Tax on Gain (@25%)	**$779,154**	**$616,616**
Total Tax Paid	**$1,395,770**	



OTHER CONSIDERATIONS

A freeze can provide additional clarity when planning for your estate. Since you have frozen your ownership interest in the company, you can calculate and monitor your anticipated tax liability at death to ensure that your estate has proper liquidity. In addition, you can take appropriate measures in your will to equalize your desired estate distributions to your various beneficiaries, taking into account the operation of the trust.

Additional planning can also be implemented to further mitigate your estate's tax exposure. This could include a wasting freeze whereby the company redeems a portion of your shares annually as taxable dividend income, providing you cash during your retirement and reducing the number of shares you own and hence your tax liability at death. Life insurance could also be incorporated as part of your planning, as the corporation could invest in a policy with a death benefit equal to the stated value of the special shares to provide liquidity on your death to facilitate a redemption of the special shares on a tax-efficient basis.

FAMILY TRUST CONSIDERATIONS

When drafting the terms of the discretionary family trust and implementing the freeze, special attention is required to ensure that the punitive attribution rules in the Act would not apply. In addition, you should consult with a family law specialist to discuss the implications for any potential beneficiary having an interest, either directly or through a trust, in the corporation.

It is important to understand that while the trust can legally exist for several generations, it is most effective for a period of twenty-one years for tax purposes before a corporate restructuring event must occur in order to avoid adverse tax implications. In an estate freeze context, this may result in the growth common shares being distributed to family members in the future, absent any additional planning.

NON-SALEABLE COMPANIES

There are certain types of corporations that will likely not be sold in the future, such as investment holding companies, real estate holding companies and certain consulting and service businesses. In such situations, the capital gains exemption is not a factor when considering an estate freeze. However, the benefits of an estate freeze in this context would be derived from the ability to potentially sprinkle income with other family members and from the tax deferral achieved for your estate by transferring the future growth of the underlying assets to the next generation.

Take, for example, a holding company where its investment and/or real estate portfolio has suffered a 35% decline due the recent economic conditions. A freeze at this point in time would correspondingly reduce your estate tax liability by 35% and, assuming a market recovery to pre-pandemic levels, transfer the rebound in value to the next generation.

Summary

Based on current market conditions, it is instructive to note the following:

- An estate freeze can be especially effective in situations where the value of the underlying company is low, since it minimizes the value of the frozen special shares you receive, which in turn affects your estate's tax liability triggered on the death of the surviving spouse.
- A depressed current value of the corporation provides the added benefit that when the value of the company rebounds, the increase will be attributed to the growth shares. The tax associated with those growth shares can potentially be deferred well into the future, especially in situations where the shares are owned by a trust and the beneficiaries include your children and grandchildren.

Placing shares with future value in a family trust can multiply the use of the capital gains exemptions if the growth shares increase in value. This will significantly reduce the family's overall tax burden in the future.

We recommend that you speak to your professional advisors regarding the contents of this article and determining if an estate freeze strategy is beneficial for your circumstances.

The strategies and considerations discussed above are general commentary in nature and may not be applicable to all situations. If you would like to further discuss whether an estate freeze makes sense for you and your business, please contact a member of our Client Wealth Management and the Wealth Planning Teams.