

## The estate freeze

An estate freeze is a transaction that may limit a business owner's tax liability at death and facilitate other tax and non-tax benefits. Estate freezes work well with life insurance to lock-in the amount of coverage needed to fund a tax liability on death.

### Taxes arising on death

Individuals are deemed to dispose of their capital property (e.g. shares of a private company) for tax purposes immediately before death at fair market value ("FMV"), unless a rollover applies<sup>1</sup>. If the assets have appreciated in value since the individual acquired them, he or she would realize a capital gain and may have to pay income tax on the taxable portion (currently 50% of the capital gain).

For example, Mr. Albert owns common shares of Opco, his operating company. The FMV of the shares is \$1,000,000 and the adjusted cost base ("ACB") is nominal. If Mr. Albert died today without a spouse or common-law partner, he would be deemed to dispose of his shares for tax purposes and realize a capital gain of approximately \$1,000,000, half of which must be reported as income in his final tax return. Assuming he's in a high marginal tax bracket (e.g. 52%), the tax liability on this capital gain would be \$260,000 and his estate and heirs will need liquidity to pay this amount.

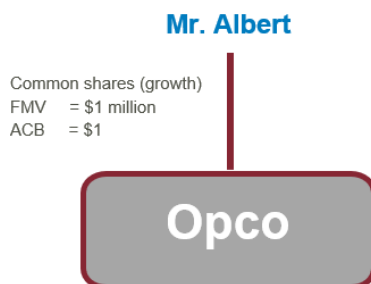
### What's an estate freeze and why consider it?

An estate freeze is a transaction that involves a business owner locking-in the current value of their common shares in fixed-value "freeze shares" and shifting the future growth of their company by having either their heirs or a family trust own new common shares. An estate freeze is typically done on a tax-deferred rollover basis so that no tax is triggered when the transaction is implemented, as discussed below.

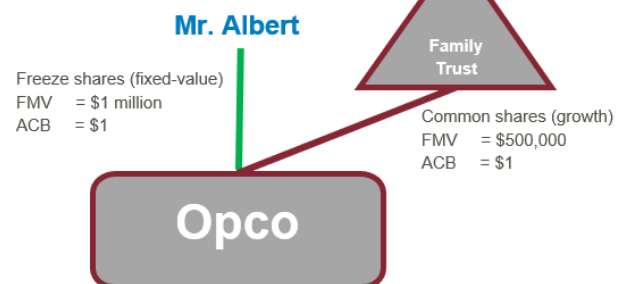
### An example

The following diagram shows the before and after corporate organizational charts of an estate freeze implemented with Mr. Albert's shareholdings in Opco (from the example above). Mr. Albert freezes his common shares at the current value of \$1,000,000 and a family trust becomes the owner of new common shares. If the value of the company eventually exceeds \$1,000,000, that difference in value will be reflected in the common shares owned by the trust. Assume in the post-estate freeze chart below that the value of the company increased by \$500,000. This increase in value is reflected in the value of the common shares held by the family trust.

Pre-estate freeze



Post-estate freeze (and increase in value)



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Freezing Mr. Albert's economic interest in the company limits his overall tax liability at death in respect of the shares. He may achieve other tax and non-tax related benefits as well, including:

**Deferring capital gains tax:** By having the growth in the company be reflected in the hands of the next generation as the common shareholders, taxes on that growth are deferred until their death, achieving a tax deferral. An estate freeze is helpful if the value of the corporation is appreciating or expected to appreciate in the future. Conversely, an estate freeze isn't beneficial if the value of the corporation is expected to decline in future; however, an estate freeze could be beneficial in a market downturn to lock-in lower values if it's expected that the value of business will recover.

**Capital gains exemption:** The business owner may consider crystallizing their lifetime capital gains exemption ("LCGE") in conjunction with implementing the freeze if their common shares are "qualified small business corporation share[s]"<sup>ii</sup>. Crystallizing the LCGE may be done using section 85 of the *Income Tax Act* (Canada) ("ITA") which allows the elected transfer price to be an amount ranging between the ACB of the shares and their FMV<sup>iii</sup>. Electing a transfer price greater than the shares' ACB triggers a capital gain that can be sheltered using the LCGE. The ACB of the freeze shares would be increased by the same amount. Freeze shares with a higher ACB reduces the capital gain arising on the death of the business owner.

**Income splitting using the new common shares:** Income splitting opportunities with family members who aren't actively involved in the business have been significantly curtailed since the introduction of the expanded tax on split income ("TOSI") rules in 2018. Despite the TOSI rules, there remains income splitting opportunities using the limited TOSI exceptions which clients should consider with their tax professional. These opportunities include relying on the excluded share exemption and income splitting with capital gains on shares that qualify for the LCGE.

**Estate planning with life insurance:** With a tax liability that can be easily estimated, the owner of the freeze shares can plan how to fund this liability. Life insurance provides liquidity to the estate to pay taxes and helps avoid the need to sell assets or go into debt. Because the insurance need is fixed, a minimum-funded universal life insurance policy or a participating life insurance policy with an enhanced coverage dividend option might be suitable product options.

**Succession plan:** An estate freeze could also be part of a business owner's overall succession plan for their business. If a family trust isn't used in the freeze, it may make sense for the new common shareholder to be a child who's active in the business and will takeover when the business owner retires. Alternatively, if a family trust is used, then the business owner has time to decide which family member(s) should directly own shares of the company. The types of trusts used in estate freezes are deemed to dispose of their capital property every 21 years. Before this 21<sup>st</sup> anniversary, a common planning technique is for the trust to transfer out the shares to a Canadian resident capital beneficiary on a rollover basis.

**Estate administration taxes and probate fees<sup>iv</sup>:** If a business owner's shares need to be probated, then freezing is a planning method for limiting any associated fees/taxes.

## Considerations

Before implementing an estate freeze, a business owner should consider if the existing value of the business and other assets are enough for his or her needs and lifestyle. If not, the business owner could consider freezing only part of his or her common shares. Also, if the company isn't a "small business corporation", generally meaning a *Canadian-controlled private corporation with less than 90% of the FMV of its assets used in an active business*, then freezing its shares in favour of a spouse and/or minor children could attract the application of the corporate attribution rule<sup>v</sup>. In addition, the

business owner will likely want to retain control of the corporation. This could be achieved by being a trustee of the family trust, owning a separate class of voting shares and/or ensuring that the new common shareholders enter into a shareholders' agreement that addresses control and other issues including a potential arm's length sale.

## Implementing an estate freeze

An estate freeze is a complex transaction that should only be implemented in consultation with experienced legal counsel and tax professionals.

There are different ways to implement an estate freeze on a tax-deferred rollover basis. Without relying on a tax-deferred rollover, a business owner could directly transfer their shares of the corporation to their heirs or a family trust; however, this would result in disposition of the shares at FMV for tax purposes – potentially creating an immediate tax liability, as well as, a loss of control over the corporation. Tax-deferred methods of implementing an estate freeze usually rely on one of sections 51, 85 or 86 of the ITA.

- Section 51 is used where not all of the business owner's shares are exchanged in the estate freeze and no consideration is taken.
- Section 86 is used where all the shares are exchanged in the estate freeze as part of a reorganization of the corporation's share capital.
- Section 85 must be relied on if a holding company is used as part of the estate freeze or where the business owner wants to trigger a capital gain to crystallize their LCGE<sup>vi</sup>.

Each method for achieving a rollover generally involves the business owner transferring their common shares to either their corporation, or a new holding company, and taking back redeemable fixed-value preferred freeze shares as consideration. The heirs or a family trust would acquire new common shares of the company for a nominal amount.

In all cases the freeze shares have a redemption value equal to the FMV of the common shares that were exchanged. The FMV should be determined by a qualified business valuator. If the business owner wants to maintain control over the corporation, special super-voting rights may be attached to the freeze shares. The freeze shares may have a dividend entitlement within a reasonable range.

## Using a family trust

As noted, a family trust may be settled to hold the new common shares instead of issuing the shares directly to the heirs. The heirs are typically designated as income and/or capital beneficiaries of the family trust. Establishing a family trust requires a trust deed, a settlor, trustee(s) and beneficiaries. The terms of the trust are documented in the trust deed<sup>vii</sup>. A tax professional should be involved with drafting the trust deed and setting up the trust to avoid the application of various attribution rules in the ITA. For example, the trust should use funds borrowed from an arm's-length third party when subscribing for the new common shares so that it cannot be alleged that trustee or beneficiary contributed property to it. This measure is taken to avoid the application of the notorious subsection 75(2) attribution rule.

## Using a holding company

Using a holding company can be beneficial if the business owner wants corporate earnings retained at the corporate level rather than distributing them to himself or herself as a shareholder and paying tax on the distribution. Holding companies can also be used as a form of creditor protection to shield corporate assets from the potential creditors of the operating company.

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<sup>i</sup> For example, where the property is transferred to a surviving spouse or a qualifying testamentary spousal trust.

<sup>ii</sup> Defined in subsection 110.6(1) of the ITA.

<sup>iii</sup> In 2020 the LCGE limit is \$883,384 and this amount is indexed each year.

<sup>iv</sup> The name of the tax / fee varies by province.

<sup>v</sup> The term “small business corporation” is defined in subsection 248(1) of the ITA and the corporate attribution rule refers to subsection 74.4(2) of the ITA.

<sup>vi</sup> Requires a joint election between the shareholder and the corporation using Form T2057, “Election on disposition of property by a taxpayer to a taxable Canadian corporation”.

<sup>vii</sup> In Quebec, a trust is generally established by a contract or will.