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Estate freezes: recognizing the opportunity

An estate freeze is a technique used to freeze the value of someone's business interest, pass the future growth in that business to someone else, and yet still control the business. This bulletin discusses some of the different types of estate freezes, some reasons for doing (or not doing) an estate freeze and some of the life insurance opportunities that arise when a client does an estate freeze.

How an estate freeze works: the section 86 reorganization

There are many ways to do an estate freeze. This section describes one way to do it. Named after the section of the Income Tax Act that governs it, the section 86 reorganization is an exchange of shares or reorganization of capital.

In a typical estate freeze, a business owner owns all the shares in the incorporated business. Usually those shares are common shares with voting rights. The owner identifies a successor or successors for the business. Often the successors are the owner's child or children, or a key employee or group of key employees.

The owner has the company redeem the owner's shares. In exchange the company issues new preferred shares with voting rights to the owner. The preferred shares have a fixed redemption value and are equal in value to the common shares just redeemed. As such, no immediate capital gains tax consequences result from this share exchange. The owner could redeem the preferred shares at any time, but only for their fixed value. Any capital gains tax consequences would be realized at that point.

At the same time, the company issues new common shares to the successors. Since the preferred shares represent all the company's value to that point, the new common shares have no value. However, any future growth in the company's value would accrue to the common shares, not to the preferred shares. The common shares would also have voting rights, but not enough to outvote the preferred shares even if a substantial number of preferred shares were redeemed. So no matter how large the company grew, the preferred shareholder would remain in control of the company until almost all of the preferred shares were redeemed.

An example may help to show how a preferred shareholder could maintain control of the company even while the company redeemed the preferred shares. The company's owner could transfer all the common shares in the company for 1,000 preferred shares. Each preferred share would have 1,000 votes (1 million votes in total). At the same time, they would have the company issue 1,000 common shares to the successors.

Each common share would have 1 vote. Under this arrangement, the preferred shareholder could redeem all but two preferred shares and still have enough votes to control the company. The owner could elect to treat the redemption of the common shares as a distribution of those shares. The owner could choose a price between the shares' adjusted cost base and their fair market value. If the company had grown in value from when the owner started it, a distribution would trigger capital gains tax. However, if the owner had some or all of the lifetime capital gains exemption available,[1] and if the business qualified for the exemption, the exemption could be used to reduce or eliminate the capital gains tax that would result. An owner considering this option needs to consider whether there will be any issues with the cumulative net investment losses account,[2] allowable business investment losses,[3] or with alternative minimum tax.[4] Regardless of whether the owner uses the capital gains exemption, the amount the successors will one day need to pay for control of the company will be frozen, and the owner's probate tax liability for the business will also be frozen.

Variations on an estate freeze: the section 85 share exchange and a trust

A section 85 share exchange is a slightly different type of estate freeze, again named for the section of the Income Tax Act that governs it. Rather than have the company redeem shares, the owner creates a holding company, and transfers the common shares to the newly created holding company. The holding company then issues preferred voting shares (in the holding company) to the owner. The holding company also issues new common shares to the owner's successors. The election referred to above, to fix the capital gain, is optional with the section 86 reorganization but required for the section 85 share exchange.

Similar to the section 86 reorganization, the superior voting power of the new holding company preferred shares allows the owner to control the holding company even though the new common shares also vote. Since the holding company owns all the shares in the operating company, the owner also controls that company, too.

An owner can also do an estate freeze by transferring the common shares to a trust. This type of freeze is often used when the intended successors are children too young to own shares.

One advantage to the trust is that it can give the owner and the owner's family some flexibility. If the children decide to not participate in the business the trustees could sell the business to a third party. Or, if the owner died prematurely, the trustees could manage the business for the children until they were old enough to run it themselves, or could manage the business for the owner's spouse until a buyer for the business could be found. Also the owner could structure the trust to reverse the freeze if circumstances changed (although the tax benefits from the estate freeze would not work as well).

Another advantage to moving the business into a trust for the children is that the trust assets can be protected from claims of the children's creditors or from inclusion in their net family property if their marriages fail.

There are some drawbacks to using a trust, though. Any property transferred to the trust is subject to capital gains tax. Trust income that is not distributed is taxed at the highest marginal rate without personal tax credits. A trust is also subject to a deemed disposition of its assets every twenty-one years, with the potential for capital gains tax consequences.

Partial estate freezes

An owner doesn't have to freeze all of the shares at once. An owner can freeze only some of the company's shares, with the option to freeze the rest at a later date. This is a way to achieve some of the aims of a full estate freeze already discussed, but still retain some right to participate in the company's future growth. A partial estate freeze may be appropriate if the owner is too far from retirement to do a full estate freeze, but needs to transfer

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[1] As of January 1, 2014 the lifetime capital gains exemption is $800,000. It will be indexed to the rate of inflation starting January 1, 2015.

[2] If you borrowed money to acquire shares in a company, the cumulative net investment loss (CNIL) account tracks the deductible loan interest that you paid to acquire those shares minus the net income you received from the shares (such as dividends). If, when you sell the shares, you want to shelter capital gains from tax by using the lifetime capital gains exemption, the exemption will be reduced by any amount in your CNIL account.

[3] Allowable business investment losses can be deducted from ordinary income. However, to the extent that you deduct such losses against income, you will not be able to use the lifetime capital gains exemption to shelter capital gains from tax.

[4] The alternative minimum tax (AMT) is a parallel tax regime imposed on high income earners. Without the AMT, such individuals could use tax breaks available to them under the normal tax system to pay very little tax or no tax at all. The AMT requires them to also perform a separate tax calculation and pay the higher of the two tax bills. AMT can produce an unpleasant surprise for someone selling capital assets. For example, if your only income for the year is the capital gain, and if you anticipate using the lifetime capital gains exemption to completely eliminate your tax liability, the AMT tax calculation may still require you to pay some tax.

some of the business' growth potential to the successors as a way of securing their commitment to the business, and tying them more closely to it.

A couple of ways not to do an estate freeze

The complexities of share redemptions, holding companies or trusts may make some wish for a simpler alternative. Unfortunately, the drawbacks from the simpler alternatives may outweigh any benefits they offer.

One alternative is for an owner to simply give or sell the shares to the successors. Unfortunately, the owner would then lose control of the company, and could lose the right to continue working there. Capital gains tax would be due immediately. The new owners could even sell the company to third parties, defeating one of the main reasons for doing an estate freeze in the first place (which is the business continuity within the family or key employees).

One partial solution to this problem is to sell the company to its new owners, taking a promissory note in exchange, rather than giving the company away or selling it for cash. The owner could then maintain control through the ability to call the loan.

As a form of control, however, threatening to call a loan leaves much to be desired. An owner could not exercise that right except in the most serious circumstances. And as the company grows and the business becomes more valuable, the new owners could pledge their shares as collateral for a loan of their own, and repay the promissory note. Maintaining control through superior voting power, offered through a section 85 share exchange or section 86 reorganization, or through a trust, is a better alternative because it relies on the owner having the legal right to control the company, rather than on a threat to call a promissory note.

Reasons for doing an estate freeze

Several reasons for doing an estate freeze have already been discussed. This section will examine these and other reasons in detail.

- Lock in capital gains and probate tax liabilities: By freezing the value of the business, the owner also freezes the capital gain and the amount that an executor will have to include as an asset for probate tax purposes. The owner will be in a better position to plan for these expenses, knowing that they will not grow.
- Lock in a purchase price for the business: By freezing the value of the business, the owner also sets the price that the future owners will have to pay for the business. The future owners will therefore be able to plan for the day when they will own the business themselves, and will be better able to complete the purchase.
- Secure a commitment to the business from its future owners: Since the successors will own any increase in value that the business experiences, they will have an incentive to work hard to preserve and increase that value. And as the value of their interest in the business grows, so does their incentive to remain with the business. The business becomes too large an asset to walk away from.
- Encourage a smooth transition: by locking in the price and securing a commitment to the business' long term future, an owner using an estate freeze helps ensure a smooth ownership transition.
- Transfer risk to future owners: since the successors will have common shares, they will have greater risk if the company goes under than the owner, who will have preferred shares. On liquidation, the preferred shareholders' claims to the company's assets are satisfied before the common shareholders' claims.
- Provide retirement income: an owner could transfer preferred shares over time to the successors. This strategy could allow the successors to buy the owner out over time, and provide the owner with a retirement income. Further, if the owner's preferred shares had enough votes, the owner could retain control of the company until almost all of the preferred shares were gone.
- Income splitting: an owner can split income with the children as the result of an estate freeze without violating the attribution rules. If the children are minors, trust income (if the estate freeze is done using a trust), dividend income and shareholder benefits will be subject to the attribution rules, but not business income or capital gains. Once the children become adults, many of the attribution rules cease to apply. Avoid family conflicts: in many families, some children will want to pursue a career in the family business, but others won't. However, the family business is usually the parents' major asset. By implementing an estate freeze, the parents can give the business to the children who one day will take over, and make plans to ensure that the children who won't get the business are still treated fairly. Life insurance can help make that happen.

- Creditor protection: if the freeze is done using a trust or holding company, creditor protection can be enhanced.

Reasons to not do an estate freeze

Of course, there are also reasons to not do an estate freeze. One of the biggest has to do with timing. Generally, an estate freeze appeals to a business owner for whom retirement is on the horizon even if it's not yet imminent. Such an owner may have children or key employees who are obvious natural successors. A younger owner's children or key employees may not yet be ready.

Another reason for not doing an estate freeze concerns the business' potential. For example, if a business is on the cusp of becoming a multi-billion dollar enterprise, its potential is worth too much to just give away. This is especially true when you consider that an estate freeze is generally irrevocable or, at least, potentially very expensive to unwind from a tax perspective.

Melts, thaws and refreezes

Melts, thaws and refreezes are ways of unwinding an estate freeze.

- Melt: after completing an estate freeze, the owner redeems shares over time in a controlled distribution. The usual purpose for the melt is to provide a retirement income for the owner from the gradual redemption of the owner's shares. The successors retain their shares. Ultimately, all the owner's shares are redeemed, leaving the successors in control of the business. This type of freeze is also called a "wasting freeze" (not in the sense that the owner's shares are wasted, but in the sense that they dwindle away over time as they are redeemed).
- Thaw: although an estate freeze is generally regarded as irrevocable, there are ways to thaw a freeze. If the owner has used a trust to freeze his or her estate, there may be provisions created to allow the business to revert to the owner. The price for such a provision would be a reduction in the tax advantages that would otherwise accrue to the owner after an estate freeze.
- Refreeze: if the value of a business has declined after an estate freeze, as it could during a recession, the owner and successors could thaw the estate freeze, even if they did not use a trust to accomplish the freeze. Generally, the irrevocable nature of an estate freeze comes from the unacceptable tax consequences that would follow strong business growth. But those consequences may be minor or nonexistent if the business has declined in value since the estate freeze. Having thawed the freeze, the owner could then refreeze the business, using the lower value that would prevail during a recession. Any capital gains exposure would then be based on the new, lower value for the business.

Life insurance opportunities

An estate freeze provides many opportunities to review the parties' insurance and financial planning needs:

- Capital gains and probate tax planning for the business owner: after the business owner completes an estate freeze, the owner's capital gains and probate tax liabilities for the business will be fixed. Even if the owner plans to gradually redeem shares, there's still a need for life insurance to pay those taxes if the owner dies prematurely.
- Capital gains and probate tax planning for the successors: if the business grows, the successors will have a capital gains and probate tax liability. While that liability can't be identified as precisely as the owner's, it still exists, and must be insured against premature death.
- Buy-sell agreement: regardless of how the owner and the successors plan to transfer ownership of the business, the owner's premature death could disrupt those plans. The parties will need insurance to make sure that if the owner dies before the business is transferred to the successors, the money will be there to complete the sale.
- Key person insurance: even though the successors may have been working in the business before the estate freeze, the freeze may provide an opportunity to recognize them as key to the business' success, and insure the business against their loss.

- Estate equalization: an estate freeze will formalize the transfer of an owner's business to the successors. If those successors are some, but not all of the owner's children, and if the family business is the owner's major asset (as it often is), the children who don't get the family business could feel as if they have been unfairly treated. But if the business is split equally among all the children, those who work in the business will feel as if they have been unfairly burdened because they will have to work to produce value and income for some of their siblings who will not work in the business. The owner will need to buy life insurance to avoid the family strife and bitterness that could result from either circumstance. Life insurance enables the owner to provide a gift for the children who won't get the business.

Advising clients

You don't need to know everything about doing an estate freeze, but it can help if you know what an estate freeze is, how it works, and why some clients may want to do one. If a client does an estate freeze, it also provides an opportunity to talk about life insurance needs, and to have a similar conversation with those who will take over the business.

Any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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