FROZEN ASSETS

If executed correctly, an estate freeze can help wealthy clients cut taxes significantly. By Gena Katz

One common estate planning strategy for an individual who has accumulated significant wealth is an estate freeze. An estate freeze refers to a transaction that fixes the value of the owner’s current position in the corporation while allowing future growth in the value of the company to accrue to other family members.

By freezing, an individual can effectively lock in the tax liability on the frozen assets that will arise on death (subject to future tax rate changes). Consequently, taxes arising on death can be minimized. Other advantages of an estate freeze include income and capital gains splitting, minimization of probate fees and facilitation of business succession.

There are a variety of structures that can be used to accomplish an estate freeze. However, in almost all situations, the corporate owner will exchange the common shares of the operating or investment corporation for fixed value preference shares of the same corporation or a new holding company. These shares would be redeemable and retractable for their current value, they would carry sufficient votes to allow the owner to retain control of the corporation and they would likely have a fixed dividend rate. The exchange would be effected using one of the rollover provisions under the Income Tax Act, so that no current tax results.

Where the corporation is a qualified small business corporation (QSBC), it is possible to trigger sufficient capital gains on rollover to use the owner’s $500,000 capital gains exemption. The gain amount will be crystallized in the cost base of preferred shares received on the exchange. On the owner’s death or when the preferred shares are sold, the $500,000 cost base can be recovered, tax free.

In the case of an operating company estate freeze, a holding company is often used. This holding company can be used to receive various non-active assets from the operating company, facilitating the continued qualification of the operating company as a QSBC. Continued QSBC status is important for two reasons. First, it allows the family members who will participate in future growth to use their $500,000 capital gains exemption in respect of a future disposition of their shares. Second, the corporate attribution rule (which imputes income to an individual who transfers property to a corporation for the benefit of a spouse or minor children) does not apply.

Corporate attribution may be a concern in the case of an investment company freeze. However, if the freeze is paid sufficient dividends each year, this rule can be avoided.

Once the value of the corporation is frozen in the new preferred shares owned by the freezezor, other family members may subscribe for newly issued non-voting common shares of the operating or investment company. At the outset, these new shares have virtually no value so the family members can use their own funds to acquire the shares, thus avoiding attribution of income or capital gains on the shares.

Alternatively, a trust could be settled with the freezezor’s children and spouse as beneficiaries and the trust would subscribe for new common shares. Using a trust provides flexibility in allocating income and future growth to family member beneficiaries on a discretionary basis. The “kiddie tax” also applies where operating company dividends are allocated to minor children.

No matter what structure is used, if the assets to be frozen represent substantially all of the freezezor’s wealth, he should ensure there is sufficient value in the frozen assets to comfortably fund future living costs, otherwise only a partial freeze should be done. It may be possible to undo an estate freeze but it may not be possible for the individual to recover any growth in the value of the previously frozen assets while the freeze was in place.

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