

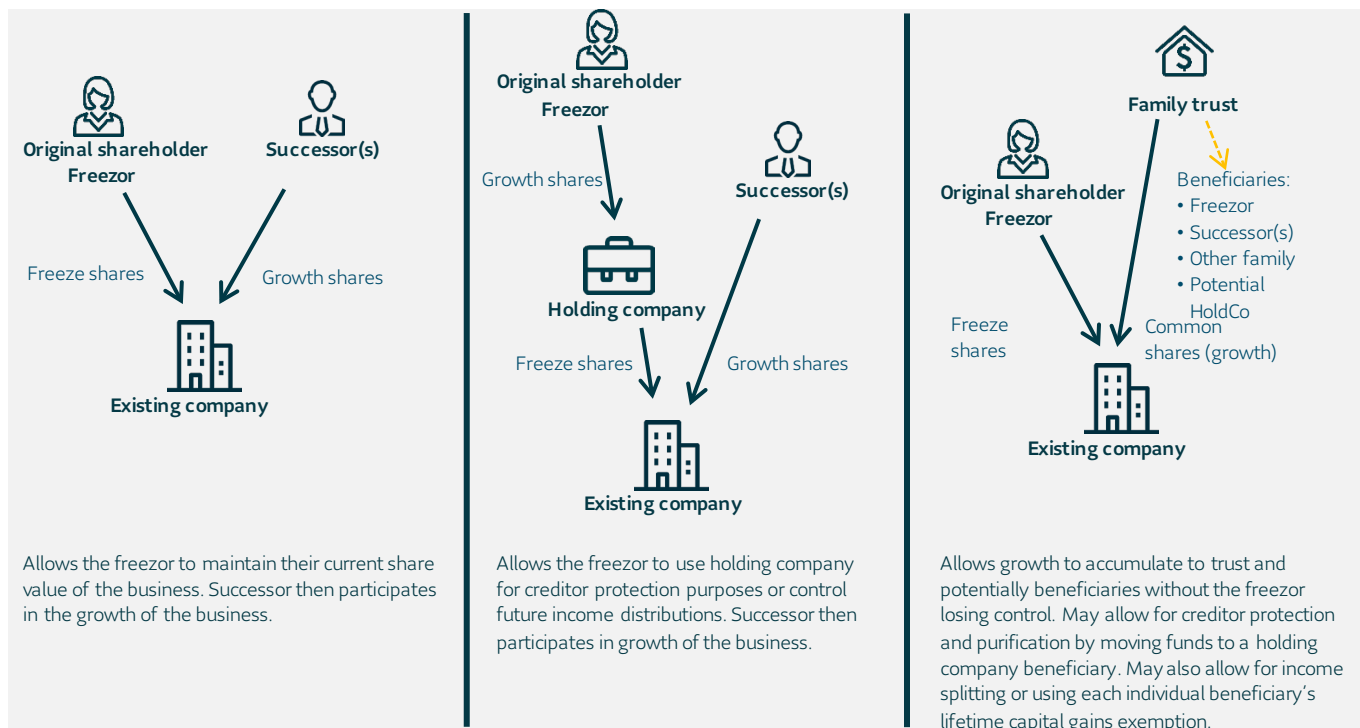
# Estate freeze – planning opportunities

For small business owners, an estate freeze is a common succession strategy and tax-planning opportunity. An estate freeze may allow you to tax-efficiently add successors to your corporation. You receive the current value of your business while your successors take part in the future growth. Alternatively, an estate freeze may allow you to reorganize your current structure for creditor protection or tax planning opportunities. We review common estate freeze methods below.

## Common estate freeze methods

A typical estate freeze has two common elements: an original shareholder (freezor) and introduction of new individuals or entities. The new shareholders may be your successors, a family trust, or a holding company depending on your planning needs. Introducing new shareholders to a corporate entity usually involves disposing all or some of your existing shares. If the fair market value (FMV) of your shares exceeds the adjusted cost base (ACB), you have a capital gain. Without the estate freeze rules, this is a taxable event for you. An estate freeze uses rules in the Income Tax Act (ITA) to defer the capital gain for the freezor. It also allows you to introduce shareholders at lower cost for them.

Common estate freezes involve the freezor transferring existing common shares to a corporation in exchange for fixed value preferred shares. The preferred shares have a redemption value equal to the FMV of the original common shares. They represent the value of your shares in the company right before the estate freeze. If you meet certain ITA conditions, the shares transfer for proceeds equal to their ACB. This results in no immediate taxes. New shareholders or entities then subscribe for new common shares in the company at a nominal value. The new common shares represent the growth of the company above the fixed preferred share value. The following diagrams show some common post-freeze structures:



Depending on your situation, your tax advisors may implement an estate freeze in various ways. Or they may implement a variation of the above. For example, they may perform a partial estate freeze where the freezor continues to participate in future growth. Or, following a freeze you may periodically redeem a portion of the freeze shares. This is commonly called a 'wasting freeze.' This provides you with cash flow to meet your retirement or other income needs. Further, it reduces the overall tax liability of owning the freeze shares as the amount of shares reduces annually.

## Using a holding company as part of the estate freeze

Instead of transferring shares to your existing company, your tax advisors may use a holding company in the freeze. A holding company can provide flexibility and control by:

- Holding cash, investments or other assets separate from the operating company. This may provide creditor protection to those assets from the operating company's creditors. It may also allow you to purify the operating company of passive assets.
- Owning other assets you want to separate from operations and succession. For example, real estate that you wish to retain and use rental income to supplement your retirement.
- Deferring taxes on annual profits you don't need for personal income needs. For example, receiving tax-free intercorporate dividends on annual profits your operating company generates. The holding company then pays the dividends out to you later when you need the funds.

A stacked holding company structure, however, may not allow you to access your lifetime capital gains exemption (LCGE) when you later sell the shares. The LCGE is available only to capital gains realized or allocated to individuals. To access the LCGE in this structure, you need to sell the shares you own in the holding company. If you accumulate passive assets inside the holding company, the shares will likely not qualify for the LCGE. Further, you may not want to sell the assets you've accumulated in the holding company. If you plan to use the LCGE on a future share sale, your tax advisors may have other recommendations. These include retaining some shares personally or using a trust. For more on the LCGE see our article **Business sale considerations when selling shares or assets**.

## Using a trust as part of the estate freeze

Instead of your successors directly owning the growth shares in the corporation, your tax advisors may use a trust. A trust can provide flexibility and control as follows:

- Growth occurs to common shares owned by the trust rather than directly to new shareholders. The trustees of the trust can then choose to distribute shares to beneficiaries later, usually on a rollover basis.
- The original shareholder maintains control of the business as primary trustee of the trust. This allows the business owner to allocate growth to new shareholders without giving up immediate control.
- Trustees can allocate dividends paid from the operating company to various beneficiaries. Paying dividends to related persons may be subject to tax on split income (TOSI) rules – see below.
- If the trust sells its shares, the trustees can allocate capital gains to beneficiaries. This may allow you to access the LCGE for each beneficiary (subject to TOSI).
- You can include a holding company beneficiary in the structure to receive tax-free intercorporate dividends. This assists in:
  - keeping the operating company pure of passive assets. This may allow you to access the LCGE when the trust sells shares.
  - providing creditor protection for the accumulated profits by moving them out of the operating company.

Usually, you use a trust in an estate freeze as a flow-through entity for income and gains. This is because the trust pays tax at the highest marginal tax rate. When used in a freeze, the trust doesn't retain income or assets in the trust other than the shares of your corporation. In addition, your tax advisors will plan to dissolve the trust prior to its 21<sup>st</sup> anniversary. This avoids a deemed disposition the ITA imposes on trusts resulting in a capital gain on accumulated growth. One choice at the 21<sup>st</sup> anniversary is to distribute the company shares to beneficiaries on a rollover basis. This form of planning is complex and requires detailed advice from your tax advisors.

## Adding a spouse, minor children or minor nieces and nephews to the corporate structure

Your tax advisors may need to plan for an income-splitting anti-avoidance provision in the ITA known as 'corporate attribution.' Corporate attribution may apply when an individual transfers property to a corporation. It occurs if a 'designated person' can receive benefits from the corporation after the transfer. Designated persons include a spouse, minor children and minor nieces and nephews.

Many estate freeze transactions involve an individual transferring property (existing shares) to a corporation. Thereafter, new shareholders (whether individuals or a trust) subscribe for the common growth shares. If the new shareholder (or beneficiaries of a trust) includes a 'designated person,' corporate attribution can apply. Corporate attribution results in harsh tax consequences if not

planned for. The ITA attributes to the transferor (freezor) an amount equal to the transferred property multiplied by the prescribed rate. This occurs in any year a designated person can receive funds from the corporation. It applies even if the corporation doesn't pay anything to a designated person in the year.

Your tax advisors may use different estate freeze methods when adding a spouse or minor relative to the structure. This could include freezes known as a 'stock dividend freeze' or a 'reverse/drop-down freeze.' Or they may pay prescribed rate dividends on the freeze shares in any year a designated person is part of the structure. Corporate attribution adds complexity to an estate freeze which requires analysis by your tax advisors.

## Tax on split income (TOSI)

The ITA also has complex TOSI rules which were expanded in 2017. TOSI may apply if a related individual receives a dividend or trust distribution from a related business. A related individual includes your spouse, children and most individuals connected by blood or marriage. If TOSI applies, the recipient of the dividend or trust distribution pays tax at the highest marginal tax rate. As a result, TOSI rules limit previously common income-splitting transactions using companies and trusts. The TOSI rules add complexity when adding a related person to the corporate structure. This is common in an estate freeze. Therefore, you may need to rely on complex exemptions to TOSI in the ITA. For example, you may pay dividends to a spouse or child over 18 who performs sufficient work for the business. Another exemption may apply for spouses over 65. We recommend your professional tax advisors assess the TOSI rules as part of your estate freeze.

## Crystallization

The above transactions result in an exchange of existing shares for fixed value shares at the same ACB. This allows the transaction to occur on a tax-deferred rollover basis under specific ITA provisions. In some cases, your tax advisors may recommend transferring the shares for an amount higher than the ACB. You then report a capital gain based on this elected amount minus the ACB. Typically, you elect to transfer at a value that creates a capital gain equal to the LCGE you have available. If your shares qualify, you claim the LCGE to reduce your taxes. This increases the ACB on your new freeze shares up to the elected amount, reducing your future capital gain. Crystallizing requires detailed analysis by your tax advisors to weigh the pros and cons. For example, claiming the LCGE may trigger alternative minimum tax calculations. This may increase your upfront tax bill and require planning to recoup the amount.

## Insurance as part of your estate freeze

At death, the ITA deems you to dispose of all your private company shares. This includes your freeze shares if you still own them. You then have a capital gain. An estate freeze allows you to manage your tax liability associated with the freeze shares. Since the freeze shares don't participate in the growth of the company, your tax liability is fixed and known. You can then purchase a life insurance policy to cover the tax liability. You can also use life insurance to equalize your estate for heirs that don't participate in the growth shares.

Depending on your structure, you may hold the policy inside your company (or holding company). This may allow you to pay premiums with lower after-tax corporate dollars. You can use permanent insurance such as a participating or universal life policy to tax-efficiently maximize your estate. During life, the policy's cash value grows tax-deferred. Upon death, your corporation receives the death benefit tax-free. In addition, the proceeds of insurance (death benefit minus adjusted cost basis) credit the capital dividend account. This allows your heirs to remove the funds as a tax-free capital dividend from the company. Speak to your financial advisor about the various life insurance options for you.

Each estate freeze or succession plan is unique to you, your current structure, and your goals. It allows you to plan for succession, creditor protection, and other tax efficient opportunities. Your financial advisor can assist you in coordinating with your legal and tax professionals to maximize your plan.

### Disclaimer

This article provides general information only. Sun Life Assurance Company of Canada does not provide legal, accounting or taxation advice to advisors or clients. Before you act on any of the information contained in this article, make sure you seek advice from a qualified professional, including a thorough examination of your specific legal, accounting and tax situation. Any examples or illustrations in this article are included solely to help clarify the information presented in this article, and should not be relied on in any transaction. Published and revised by: Estate & Financial Planning Services. Last revised January 2023 Sun Life Assurance Company of Canada is the insurer, and is a member of the Sun Life group of companies. © Sun Life Assurance Company of Canada, 2023.