Estate Freezes

As your clients grow and age, they may be continue to own shares of their corporation. If they were to pass away (assuming no spousal rollover), they are deemed to dispose of their shares at fair market value and be required to pay the tax on these gains accordingly.

An estate freeze is something to consider. The main purpose of an estate freeze is to reduce the growth of the shares owned by a specific shareholder (typically an aging parent) in favour of another person (typically a child). These are used for both succession planning and to minimize the future income tax as a result of the death of an aging parent.

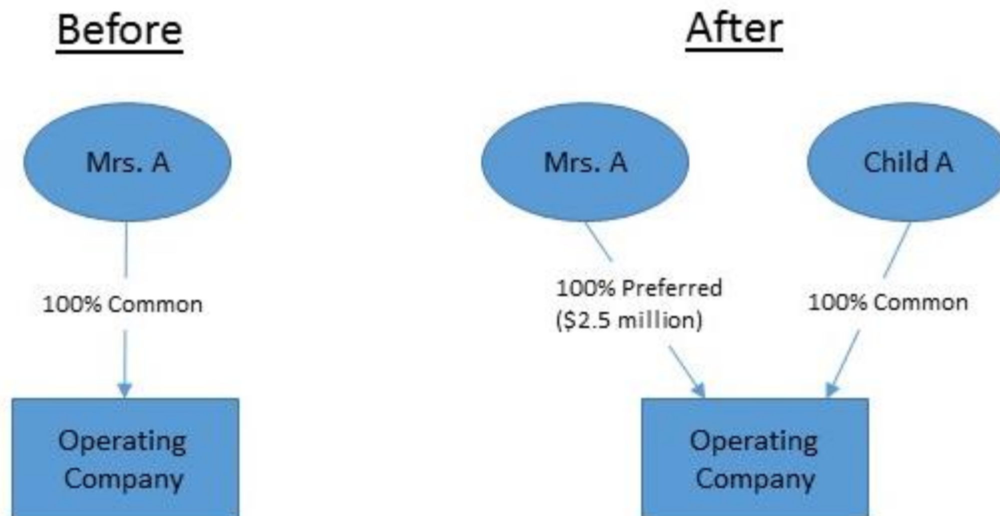
There are a number of ways to complete a freeze. One method would have the parent exchange their existing common shares into preferred shares. These preferred shares would have a fixed redemption value equal to the current value of the company. New common shares would then be issued to the next generation at a nominal amount. The future growth of the company would then accrue to the new common shares.

Another alternative would be using a family trust to acquire the new common shares. A family trust can offer more flexibility in the future by having the shares owned on behalf of the family instead of a specific person.

Example

Mrs. A owns 100% of the common shares of a successful business worth approximately $2.5 million dollars. Mrs. A is entering her mid-60s. Her son (Child A) has been active in the business for a number of years. If Mrs. A were to pass away, her Estate would owe approximately $622,000 in income taxes on the value of the business (assuming the capital gains exemption does not apply).

Mrs. A could exchange her existing common shares for preferred shares with a fixed redemption value of $2.5 million. Child A would then subscribe for the new common shares for a $10. As the company continues to grow, value of Child A's common shares increases. The value of Mrs. A's preferred shares are still fixed in value and therefore her tax exposure of $622,000 does not continue to increase.



Considerations

A couple of things to consider:

Valuation

How are the existing common shares valued? Should you engage a Chartered Business Valuators (CBV) or other valuation experts (ie. real estate appraiser)? The overall bias would be to have the valuation be on the lower end of a range (to reduce potential income tax exposure). However, the valuation needs to be reasonable. A price adjustment clause also should be used in case the CRA proposes to adjust the valuation of the shares.

Voting Control

Does the aging parent want to maintain the voting control of the company? This can be through either voting preferred shares or skinning voting shares (i.e. non-participating common shares). If so, then when is the right time to transfer the voting control to the next generation?

Wasting Freeze

Once the shares are frozen into preferred shares, how do you plan on reducing the value of the preferred shares? The one way is to redeem the preferred shares on an annual basis so that the aging parent receives a portion of the redemption proceeds and has regular cash flow. The deemed dividend on the redemption would be included in their income and taxed based on their marginal tax rates. This would then reduce the tax exposure on the preferred shares on their passing. An alternative might be a capital gains strip.

Note: These types of transactions are extremely complex and the risks should be discussed with your clients prior to implementation.

Disclaimer: Information is current to November 26, 2019. Tax legislation, interpretations, and administrative positions change constantly; therefore there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future.

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