CORPORATE Newsletter

February 2017 Issue 39

Estate Freezes

IN THIS ISSUE

What is an Estate Freeze?

What is the Purpose of an Estate Freeze?

When is an Estate Freeze Appropriate?

Non-Tax Considerations
Tax Considerations

What is an Estate Freeze?

An estate freeze refers to planning that has the effect of transferring the future growth in value of a business, investments, or other assets into the hands of subsequent generations. The current owners (typically the parents) are effectively divested of this future growth. An estate freeze typically limits the value of the parents' estate to the value at the date the freeze is implemented (the freezor typically retains the current value of the asset, although often in a different form). Accordingly, capital gains and other tax exposure on the future growth that would otherwise be taxed in the hands of the parents when the assets pass from parents to children are taxed in the hands of the children instead.

What is the Purpose of an Estate Freeze?

The main reason to implement a freeze is to maximize the value of the estate that will ultimately pass to the freezor's beneficiaries. The transfer of capital gains and other tax that would otherwise be incurred on the transfer of appreciated assets to the next generation means that the beneficiaries will receive more. An individual is deemed to dispose of his or her capital property on death at fair market value, so reducing the value of one's property that will be subject to these deemed disposition rules serves to maximize the value of the assets received by the beneficiaries. For this reason, an estate freeze is implemented when the assets of the freezor are expected to appreciate. If the assets are expected to depreciate, it is usually preferable not to implement an estate freeze.

When is an Estate Freeze Appropriate?

Before recommending implementing a freeze, your tax adviser will review the pros and cons of doing so. A freeze isn't necessarily always advantageous.

Non-Tax Considerations

There are a variety of non-tax related factors relating to estate freezes, such as the following.

1. **Inflation** — It is important to ensure that inflation of living costs over their lifetime following the freeze does not leave the parents without sufficient wealth to live comfortably.

2. **Personal Issues** — The psychological (not to mention legal) effects of income splitting as well as estate freezing should be considered carefully, as the outcome may be to place substantial assets in the hands of the children. These effects should be considered carefully, from the point of view of both the parents and the children.
3. **Family Law** — Family law and asset protection considerations should be addressed. For example, parents are sometimes reluctant to transfer their wealth to a married child due to the prospect of the spouse taking some of that wealth if the marriage breaks down in the future. However, there are ways of alleviating such issues with clever planning.
4. **Other Asset Protection Issues** — Shares held by parents could be subject to claims as a result of personal guarantees, judgment creditors, etc. Depending on the circumstances and the structure of the estate freeze, a degree of asset protection may be possible with respect to shares held by children, with even greater protection if the shares are held by a trust.
5. **Post Mortem Holding Period** — If the assets to be frozen are likely to be sold on or shortly after the death of the parents at a point in time when both parents and children are in the top tax bracket, there may not be too much point in effecting an estate freeze, since the children will have to pay tax on the sale of the assets at that time in any event.

In other words, a freeze is typically most effective when the frozen assets are held long-term by the children. Often, assets that are considered by the parents as long-term holdings may not in fact be such once the parents pass away. A vacation property might not be perceived to be as desirable to the children/grandchildren as it was to the parents (or may become undesirable due to inter-family strife after the parents pass away). Children may have a very different view of marketable securities that were perceived of by their parents to be long-term family assets.

In recent years, a more fundamental issue has arisen in terms of preservation of family wealth: the presumption — valid in previous generations — that the children will be motivated to carry on a family business or otherwise continue to hold assets, may no longer be well-founded. The work ethic taken for granted by previous generations may be eroded by decades of affluence, resulting in a very different mindset of the children. Far from wishing to take over the family business, or pursue a lucrative, but demanding career, the children's financial prospects may be based on the affluence of their parents. Real estate and other assets that were treasured by the parents may be used to finance the lifestyle of a succeeding generation. A family business — with all its pressures and responsibilities — may be put up for sale once the parents are out of the picture. It may not be the happy situation parents envisioned for their children years ago, but it's a growing fact of life.

Tax Considerations

The following are some tax considerations relevant to whether a freeze should be implemented.

1. **The Small Business Deduction** — Traditionally, the small business corporate tax rate applicable to active business income has been much lower than the top personal tax rate. This, of course, encourages the retention of earnings at the corporate level, up to the annual "small business limit" ($500,000 per associated group of corporations). Therefore, there is a substantial incentive to retain profits at the corporate level up to the small business limit, rather than distribute them as dividends or salaries and thus incur additional tax exposure. Of course, the retention of corporate surplus results in otherwise higher tax exposure when the owner eventually passes away.
2. **Capital Gains Exemption** — Another crucial consideration is whether the capital gains exemption can be triggered on the freeze and/or will be available to shelter tax exposure when shares eventually pass from the parents to the children. The capital gains exemption

can shelter up to $835,716 of capital gains ($417,858 of taxable capital gains) on shares of a qualified small business corporation. Or with respect to qualified farm or fishing property, the exemption can shelter up to $1 million of capital gains ($500,000 of which are taxable capital gains). Given the potential tax savings that the exemption can provide, attention must be paid to matters such as the asset composition and thereby the eligibility for the exemption.

3. **Income Splitting** — An estate freeze will, by necessity, involve the introduction of family members as shareholders. As a result, therefore, there is a potential for tax savings if family members are in low tax brackets. However, the tax rules and potential pitfalls involved can be complex, which brings us to the final consideration.

4. **The "Kiddie Tax"** — The advantages of income splitting in respect of an estate freeze are greatly restricted by the so-called "kiddie tax". It is a special tax — at the highest rate — to individuals who have not turned 18 in the year. It applies to taxable dividends (and other shareholder benefits) from private-corporation shares, among other forms of income. However, the kiddie tax does not apply to individuals 18 and over in the year, nor does it apply to spouses or parents.