

The Estate Freeze

Putting tax on ice

THERE IS PERHAPS NO GREATER SATISFACTION for an individual taxpayer than to be able to tell the tax collector, “Just wait!”

This is stated with the full respect that as a society we require a properly functioning tax system to enable our economy to operate effectively. Still, if there are legal means available to defer a payment then it would be crazy not to explore *how to put tax on ice*.

An “estate freeze” is a term most often attached to the succession planning activities of a small business entrepreneur, though it may potentially have application for portfolio investors in some circumstances.

What is an estate freeze?

Though the term would likely sound obscure to the general public, an estate freeze is a commonly available wealth technique that can make the succession of selected assets more tax efficient. In this context, the term ‘tax efficiency’ may be a combination of:

- Deferral of a taxpayer’s existing inherent tax liability from a current to a future payment date, often aligned with the taxpayer’s death or a spouse’s later death
- Transfer of future growth and tax liability from a taxpayer to a child, grandchild or other person, usually extending time horizons and possibly accessing lower brackets
- Potential ongoing management of the timing and distribution of tax on the growth using existing, newly-created or

future-planned trusts, partnerships or corporations

While the legal structure and components may vary, the general principle of a freeze remains constant: Lock in the value of chosen assets without triggering tax, while deferring the tax on future growth for years or even decades.

Purpose of a freeze

But let’s not put the cart before the horse.

These tax benefits must follow from the core purpose of an estate freeze, which is to facilitate the orderly transition of selected assets to those whom the taxpayer wishes to benefit, generally being those to whom estate assets would otherwise pass in the traditional sense. (As children are the usual recipients, that will be the term used from here on, but it is certainly possible to pass on to later generations and non-family recipients if desired.)

The bonus with an estate freeze is that, by managing the tax liability early on, more can be expected to pass on.

Ready to proceed?

The decision to undertake an estate freeze has to be considered very carefully. Invariably it involves changes to legal ownership of assets – and it is often irreversible once implemented. Above all else, the would-be parent/freezor must be certain that there will be adequate assets remaining under his/her ownership and control to continue to live a comfortable life unfettered by nagging tax and legal thorns.

Of course, the ultimate benefit of the estate freeze accrues to the children carrying on after the parent has passed on. The goal of the freeze is to allow for the greatest value to be received by the children, and the early crystallization of tax in a freeze can assist in that regard. Even so, it would be folly to focus so tightly on the tax bite – and early timing in particular – to the extent that the assets become exposed to even greater loss risks, possibly cutting off other planning options.

While it may be technically possible to freeze an estate at almost any point in time, it may be ill-advised or at least premature in situations where:

- The candidate is a young person, perhaps unattached and without children, bringing into question whom the freeze will favour and whether that is a desired permanent result
- The children are young (whether or not of minor age), making current asset ownership impractical, and even near future ownership an unpalatable outcome
- The candidate’s marriage is not on the strongest footing, raising the spectre of a division of assets, child support and/or spousal support, which taken together could negate the benefits of a freeze (or be exacerbated by the cost of undoing a freeze)
- Despite being at a reasonable age, the children may have marital, creditor, disability, mental health or addiction issues, any of which would militate

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strongly against implementing a freeze, or if doing so then would warrant very firm strings attached

- Where the candidate is at a fairly advanced age, the tax deferral from the freeze will be somewhat limited in time, and thus the scope of a freeze may in turn be limited, or preferably coordinated with some strategic testamentary trust planning in the Will

The motivation to reduce eventual tax liabilities must therefore be tempered with the practicality of age, life stage, maturity and vulnerabilities of both the parent as benefactor and the children as beneficiaries.

Assuming that these hurdles have been addressed, what does a freeze actually look like?

The business freeze scenario

Take the classic example of an entrepreneur who has invested a significant amount of time and capital into the growth of a small business corporation. Inherent in that built-up growth can be a substantial tax liability, even with the expectation of using the \$750,000 lifetime capital gains exemption for shares of a small business corporation. Assuming a positive outlook for business growth, that attached tax liability will only get larger.

In fact, if left unmanaged, the tax incursion could inconveniently come due at the entrepreneur's death, potentially threatening the viability of the operation as a going concern. This in turn could lead to a fire sale of the business or its assets in a desperate attempt to find liquidity to service the tax obligation, further imperiling family wealth.

In an effort to contain that tax liability and protect future value, an estate freeze could be implemented as part of a broader business succession process. The components of the larger plan would include:

- Detailed analysis of the business itself, and specifically the technical skills required of current and future management and ownership
- Candid consideration of the soft issues motivating the founder, including an honest introspective of personal/parental motivations and expectations
- Tough love. A frank examination of the children, placing their capabilities, limitations and personalities under a bright light
- Consideration of the reaction of constituencies within and surrounding the business, including employees, suppliers, customers, bankers – and those children who are projected to take on less-favoured roles (whether actual or perceived)
- Review of asset holdings to isolate and realign appropriate assets for tax restructuring, while of course preserving the integrity of the business
- The freeze. Crystallization of tax through creation of legal structures (trusts, corporations or partnerships), execution of asset transfers and necessary tax elections
- Allocation of future growth to the successors through one or a combination of corporate share issuance, beneficial trust entitlement, or partnership interest, all in such proportions and subject to such limitations built into those legal structures

- Assuring later estate liquidity by obtaining life insurance coverage aligned to the determined tax liability, usually joint-last-to-die coverage for founder and spouse, given the availability of asset rollovers at tax-cost basis between spouses at first death
- Insulating against the children's risk events through a wide variety of measures including shareholder agreements, key person insurance for those with active roles in the business, matrimonial contracts and Will & estate planning

As this series of activities shows, the technical freeze is really part of the end-product implementation of a lengthy and potentially very challenging process. Its ultimate form will be dictated by circumstances, being as simple or complex as needs may require.

Freeze mechanics

For a business to be of sufficient value to warrant an estate freeze discussion, it is a given that the existing business form will be a corporation. The mechanical procedure then is to make adjustments to the entrepreneur's/freezor's share interest so that current value is frozen, and future value can be shifted to the children.

The most common procedure for doing this is for the freezor to exchange current common shares for one or more new classes of preferred shares having a fixed value equal to the value of the original common shares at the time of the exchange. Growth in the future value of the business will accrue to one or more other share classes. The preferred shares will have a number of features that preserve

The Estate Freeze (cont'd)

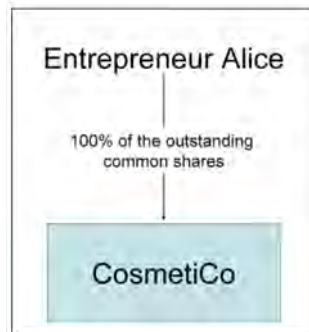
both value and control (with these two elements sometimes separated between classes), generally including:

- A corporate redemption option and shareholder retraction option, both aligned with the current/freeze value of the corporation
- A priority right to return of capital if there is a wind-up of the corporation. This priority is as against all other share classes, but does not guarantee the full return of capital if corporate assets have depleted or there are superior creditor claims
- Voting control (or at least participation) in order for the freezor to monitor activities and possibly re-assert management control over the business
- A dividend. The preference, accumulation and triggering features of the dividend can be catered to the freezor's needs and desires
- Of key importance, a 'price adjustment clause' to provide protection (though not a guarantee) against future tax liability should the freeze share valuation be challenged by Canada Revenue Agency

It is usual that these shares will remain outstanding until the death of the freezor, or last death of freezor and spouse. Nonetheless, it may be that a redemption schedule is followed so that the freezor is eased out of the business, both from a financial and a control perspective. In particular, where the freezor may be at less than top marginal tax bracket in very senior years, it may be sensible to trigger some of the tax liability early, rather than awaiting an inevitable large tax bill in the estate.

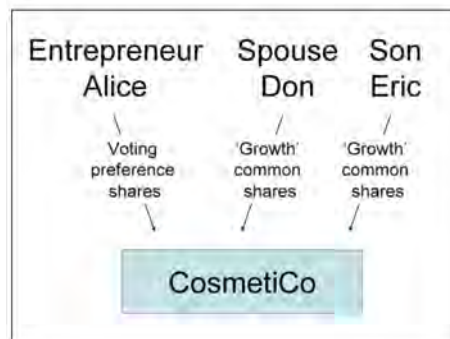
A progression of freeze examples

Let's consider entrepreneur Alice Bolton and her successful make-up distribution and retailing operation run under her corporation, CosmetiCo. Alice has gone through the analysis and is ready to implement an estate freeze. She has a husband Don and adult child Eric.



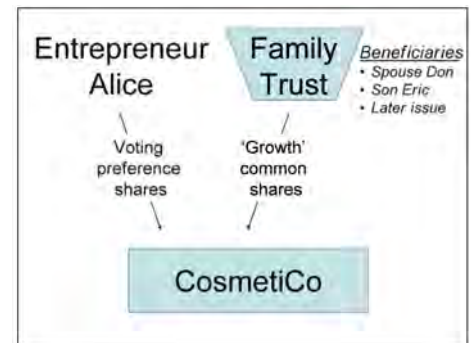
Simple freeze

Alice and her professional advisors may be content that there are no serious complications to the business or the people involved. Accordingly, an option with the least 'moving parts' is what is desired. Alice could do a basic share-for-share exchange to effect the freeze, and have the growth shares issued directly to Don and Eric. Whether Don would be included in this manner would depend on valuations and respective wealth positions of Alice and Don.



Freeze with added family trust

On further consideration following conversations with her legal advisors, Alice might be a little concerned about the untethered wealth transfer to son Eric. She may be especially uncomfortable with the potential that his interest in the business could be exposed to his creditors, open to matrimonial claim with a later spouse and generally be subject to his own lack of maturity. By adding a family trust as a layer that separates beneficial entitlement from legal ownership, Alice can take some solace that these risks are mitigated, particularly if she is a trustee of the trust.



Freeze with additional corporations

With the input of her tax advisors, Alice may come to the conclusion that one or more additional corporations may be appropriate:

A holding company interposed so that excess cash may be pushed out of operating companies where tax status and creditor issues may be of concern

A separation of the operating company into a RetailCo and DistributeCo, based on distinctive business needs and to prepare for a potential later spin-off

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One or more RealtyCo's for real estate no longer used in the business, which again may have implications for tax status, as well as non-business liability exposure.

As can be appreciated, the legal and tax issues become increasingly complex as values, number of holdings and parties to the proceedings increase. The estate freeze can usually be scaled upward to capture such concerns, though of course implementation costs will also rise, which may become difficult to justify when planning against more remote contingencies.

The investment freeze candidate

As mentioned at the outset, the principles of an estate freeze need not be limited to business situations. In fact, the business example can be instructive as to the positioning of the estate freeze as an end-product of a clearly considered planning process.

In qualified circumstances, a portfolio investor may be able to make use of corporations and trusts to implement a freeze, but the assistance of tax professionals is a must before taking action. Certainly for wealth generated within an active business corporation and migrated

into a holding company, the strategies used in the business estate freeze are fairly easily transported into an investment freeze.

Variations for later planning

Thaws, melts, gels and re-freezes are cute terms used to describe sophisticated planning alternatives for contingencies that may arise down the road.

The key issue to recognize is that, with the right planning, there is great latitude in how an estate freeze may be structured from the beginning, including the flexibility to build upon, re-cast or undo the process, as later circumstances may require.

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