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Estates, trusts and wealth management

Should you be considering an estate freeze?

Briefing

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If you own assets that are expected to grow in value, such as shares in a privately held company, a portfolio of investments or land, you may be able to arrange your affairs so as to minimize income tax on any future gain in the value of those assets, lower provincial probate fees payable on your death, and plan for the orderly succession of your wealth into the hands of the next generation. These are some of the objectives that lead people to consider an estate freeze.

What is an estate freeze?

Simply put, an estate freeze is a transaction which limits, in whole or in part, the future growth in the value of assets ("original assets") by having the owner of those assets (the "freezor") exchange them for assets that have a fixed value ("frozen assets"). After the freeze, growth in the value of the original assets will accrue to the benefit of other persons, often children and grandchildren of the individual carrying out the estate freeze (the "freezor") or a trust established for their benefit.

Implementing a freeze

Typically, the freezor transfers his or her original assets to a holding company in exchange for voting preference shares of that company. The value of the preference shares received will be equal to the value of the original assets at the time of the transfer and the preference shares will not increase in value in the future. In this way, a "freeze" of the value of the original assets owned by the freezor is achieved.

The holding company then issues non-voting common shares to one or more new shareholders designated by the freezor (often his or her children or grandchildren) or to the trustee(s) of a family trust established for their benefit. Any growth in the value of the original assets after the freeze will accrue to these new common shares. Very often the freezor will continue to control the holding company through the ownership of the voting preference shares.

Many variations of this structure are possible. The final plan should be designed to achieve the specific objectives of the freezor and reflect his or her personal and financial circumstances as well as those of family members or others who are intended to benefit from the freeze.

Potential advantages associated with an estate freeze

1 Income tax advantages

Because the preference shares that the freezor receives will not increase in value, the capital gain on those shares, when they are eventually disposed of, will not increase. This means that some degree of certainty is achieved in terms of the tax payable in respect of the preference shares on the death of the freezor.

If the estate freeze is structured so that any increase in the value of the common shares accrues to the freezor's children, assuming that the children outlive the freezor, this will result in a deferral of the tax liability associated with that increase in value until the child who receives shares either disposes of them or dies, whichever first occurs. Even if the tax deferral is only for a few years, depending upon the amount involved, this can result in a substantial benefit to the next generation.

The tax payable on the disposition of shares of the holding company by the freezor and the children can be further reduced by having each of them use his or her small business capital gains exemption, if it is available.

There is also the possibility of "income splitting" with the children and grandchildren of the freezor. As recipients of dividends on the shares that they hold, they will often be in a lower tax bracket and therefore be taxed at a lower rate than the freezor; however, certain "attribution" rules in the Income Tax Act (Canada) can negate any income splitting benefits. The greatest flexibility to income split will generally exist if children or grandchildren are 18 or older.

2 Reduction in probate fees

Through careful planning, provincial probate fees payable by the estate of the freezor on his or her death can also be reduced and, in some instances, eliminated. This may be achieved through the redemption of the preference shares while the freezor is alive (called a "wasting freeze"), through the use of multiple wills, or by transferring shares to an alter ego or joint partner trust, the latter option being available if the freezor is 65 years of age or older.

3 Family legacy assets

An estate freeze can also be an effective component of a plan designed to pass ownership and control of a family legacy asset, such as a family business, into the hands of the next generation. The use of a trust as part of the plan can ensure that the structure is flexible, giving the freezor time to consider, for example, which of his or her children or grandchildren are best suited to take over the control of the business when the freezor is ready to relinquish that control.

4 Asset protection

The interposition of a holding company and a trust may also provide asset protection in some circumstances for family members who might be faced in the future with a claim by a disgruntled spouse under family law legislation or by a creditor. However, the extent of this protection will depend on a number of factors and legal advice should be sought if this is a concern.

Timing of an estate freeze

The timing of an estate freeze depends upon many factors, including, for example, the personal and financial circumstances of the freezor and those of his or her family members, as well as the nature of the family business, if one is involved. One of the biggest mistakes sometimes made is putting in place a structure that does not have sufficient flexibility to accommodate future changes in circumstances and needs. If proper care is not taken, a freezor can be left with inadequate assets to sustain his or her lifestyle and support future business plans. A proper estate plan should ensure that this does not happen.

Conclusion

Even where it is appropriate to implement a freeze, it will likely be only one component of a well-designed estate plan intended to achieve a client’s objectives. The lawyers in our estates, trusts and wealth management group would be pleased to work with you to design a plan that works for you.

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