Estate Freeze and Transfer of a Business

It is often said: “there are only two things that are certain in life: death and taxes”. Very few know how true this is, in fact, the death of a taxpayer results in the incapacity of the latter to generate income and pay taxes. *The Income Tax Act*[1] (hereinafter the “Act”) provides that a taxpayer, at his death, is deemed to have disposed of all of his assets at their fair market value and is required to pay tax on any gain realized[2]. For a taxpayer who has spent the last twenty or thirty years of his life building up his business, this could prove to be a disaster and even threaten the survival of his business after his death. It is therefore important to set up certain measures that will reduce taxes upon the death of the taxpayer and will favour an efficient and orderly transfer of the business. The most frequent measure with regards to business transfers is without a doubt an estate freeze. This text will outline a description of the principal techniques offered in the matter of estate freezes.

1. Example

Let us take the example of Mr. Anyman, a sixty-five year old businessman who set up his own business in 1980. When the business was started, the common stock he owned had an adjusted cost base (hereinafter “ACB”), a paid-up capital (hereinafter “PUC”) and a fair market value (hereinafter “FMV”) of $100. Twenty-five years later, at Mr. Anyman’s death, the company’s FMV is $5,000,000. The capital gains tax would represent an amount of $1,250,000 or $1,080,000, if Mr. Anyman can use his $500,000 capital gains exemption[3]. His estate may have to sell the business or some of its assets, in order to pay the tax bill. Of course, a life insurance policy could have been taken out in order to reduce the tax burden but there are circumstances where this is either too expensive or even impossible, depending on the health or age or Mr. Anyman.

2. Tax free roll-over to the spouse or common-law partner or in favour of an exclusive spousal trust

If no structure for the transfer of the company was set up before the death of Mr. Anyman, the tax-free rollover in favour of the spouse or the common-law partner (hereinafter collectively referred to as “Spouse”) or of an exclusive spousal trust in her favour would certainly constitute the safest course, if not the only plan available, for Mr. Anyman[4]. Any tax would then be deferred until Mrs. Anyman sells the property or dies. Mr. Anyman would be deemed to have disposed of his property at its cost amount[5] and no capital gains tax would be due at his death. It should be noted that in the event that Mr. Anyman has already prevailed himself of his capital gain exemption, that this would not prevent his Spouse from doing the same in the future. The roll-over would therefore allow doubling up of the capital gains exemption.

In the opposite case, Mrs. Anyman could also prevail herself of the exemption but Mr. Anyman would have no right to it, since the disposition at the cost amount provided in subsection 70(6) of the Act, which allows for the tax-free rollover of the deceased assets to the Spouse automatically applies. Finally, if it is true that a roll-over in favour of the Spouse or to a trust in her favour would allow to defer the tax until her death, it should be understood that the latter will become a shareholder of the company and, consequently, will eventually have to make the decisions pertaining to the transfer of the company which the deceased did not make while he was alive.

3. Estate freeze as a solution with regards to the transfer of a business

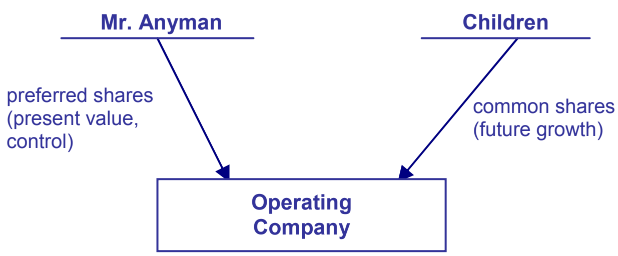
A better solution which would allow the business to be easily transferred, perhaps even gradually, is to proceed with an estate freeze in favour of family members or in favour of a trust *inter vivos* in their favour. Several techniques can be used by a person who wishes to withdraw himself while progressively converting his participation into cash. We will describe the two most frequently used techniques: the internal exchange of shares and the external sale to a holding company.

3.1 Internal freezing by exchange of shares

This technique involves the exchange of the common shares of Mr. Anyman for preferred shares. It will be possible for Mr. Anyman to choose an agreed amount[6], enabling him to trigger a capital gain in order to crystallise his $500,000 capital gains exemption or simply to transact at their cost amount, thus avoiding all tax consequences[7]. Thereafter, family members of Mr. Anyman can, directly, via a holding company or via a trust created in their favour, subscribe for newly issued common shares.

The exchange of shares with direct holding or via a company is very simple and relatively inexpensive. However, the disadvantage involved with the use of this technique is that the beneficiaries of the freeze become direct shareholders of the company. This can cause certain income attribution problems[8] for Mr. Anyman and can cause a problem if he later decides to sell the company to third parties.

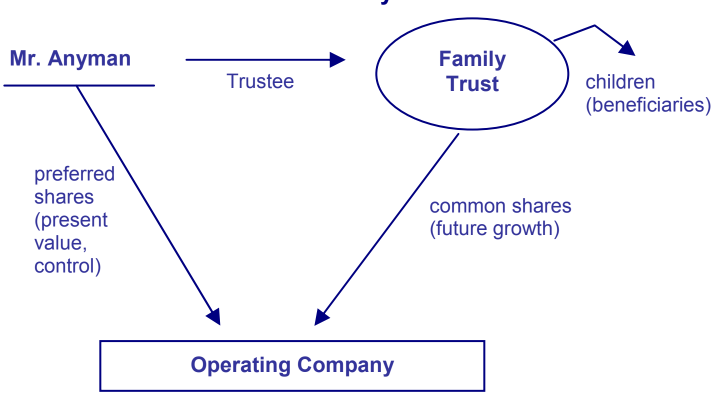
Exchange of shares with direct shareholding



3.1.1 The advantage of using a family trust

The holding of newly issued common shares by a family trust has several advantages: (1) the possibility of multiplying the capital gains exemption; (2) the possibility of keeping the control of the management of the company by ensuring that Mr. Anyman is the trustee, (3) the non-application of the rules pertaining to income attribution; (4) the possibility of income splitting between the family members of each child; (5) the possibility, when the trust is wound up or at another time, to give a greater number of shares to those children who are more active in the business, at the discretion of Mr. Anyman while he is the trustee, (6) the possibility of avoiding tax to be paid in the event of the death of one of the children, when it occurs prior to the liquidation of the trust, as well as the increase of the share of the surviving beneficiaries and, finally, (7) the possibility of proceeding with a de-freeze if Mr. Anyman is also a beneficiary. In this context, the cost of setting up and maintaining a trust is relatively low when compared to the flexibility and advantages that it can give to Mr. Anyman.

Use of a family trust

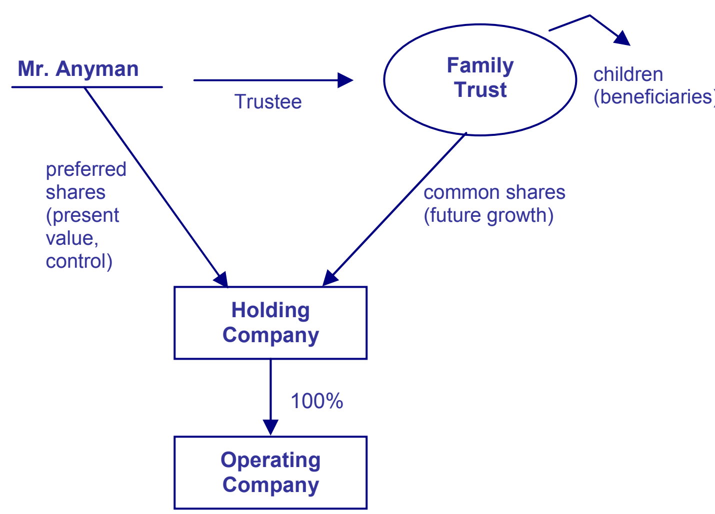


A family trust created *inter vivos* is subject to a deemed disposition (taxation of the accumulated appreciation) of its property twenty-one (21) years after the date of its creation, which will largely leave time for Mr. Anyman (who will also be trustee) to plan the transfer of the company. This event can easily be planned at the same time that the trust is created. Furthermore, contrary to the date of death, that of the deemed disposition, twenty-one (21) years from the creation of the trust, is known in advance. Unpleasant surprises can thus be easily avoided.

4. External freeze

One of the other techniques frequently used is the sale by way of tax free roll-over to a holding company directly held by the members of the family or via a family trust. Under this scenario, Mr. Anyman would exchange his common shares against preferred shares and common shares will be subscribed for by his children or a trust. The share capital of the holding company can include common shares, preferred voting shares, the holding of which allows to control the company, preferred rollover shares and other classes of shares can be authorized, as required. An agreement of sale and roll-over tax forms are completed[9]. Once again, the issue of income attribution will have to be planned in advance. This is why it is still highly advisable to set up a trust between the holding company and the beneficiaries. The comments previously made concerning the trust (section 3.1.1) will also apply. The trust can also be used to extract excess cash from the operating company and the holding company to ensure they continue to qualify as small business corporations[10] for purposes of the capital gain exemption.

Use of a holding company



5. Conclusion

Let us take, once again, the example of Mr. Anyman. If we assume that he put in place an estate freeze of his shareholdings in 1998, seven years before his death, at the time when the company was worth $3,000,000 in favour of a family trust benefiting his wife and three children. At the time of the transfer, Mr. Anyman crystallized his $500,000 capital gains exemption. During the following seven years, his company repurchased $100,000 worth of shares from Mr. Anyman each year, thus spreading out the tax to be paid over several years. At the time of his death at the beginning of the year 2006, the total value of the company will be $4,300,000, allocated as follows:

Mr. Anyman: $2,300,000 less a tax cost of $500,000

Family trust benefiting the wife and three children: $2,000,000

The total income tax burden that Mr. Anyman's estate will incur is $658,640 of which $433,800 will be payable in the year of his death, the tax payable on the yearly dividends having been already paid. This represents a tax saving of $421,360. If Mr. Anyman had chosen not to repurchase shares, the tax payable would have been $554,300, resulting in a tax savings of $525,700. It must also be recalled that the estate freeze combined with using a trust will have made it possible to transfer $2,000,000 of value to Mr. Anyman's wife and his three children, on which they may eventually be able to claim the capital gains exemption. It is therefore the equivalent of more than half of the company value that will be exempted from tax, at the time of Mr. Anyman's death, due to the planning of the transfer of company. We should add to that that the adult children can receive dividends during the lifetime of Mr. Anyman without the attribution rules applying further to the acquisition of their participation in the company.

In conclusion, we can summarize the advantages to carrying out an estate freeze in the following way: benefitting from current tax measures (capital gain exemption), income splitting, training of the future generation who will take over, orderly integration, gradual transfer of control of the company to those children most capable of managing it and triggering the tax gradually. It is up to each concerned individual to take the necessary measures to reduce the tax burden which he will leave to his family at the time of his death. That is why the strategy explained above will have to take into account the economic situation of the concerned individual (RRSP, residences and other valued possessions, life insurance) but also of his matrimonial and family situation so that the estate freeze really fits in with a coherent and efficient estate and will planning strategy.

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1 R.S.C. 1985, c. 1 (5th Supp.), as modified.
2 Ibid., at para. 70 (5) (5.1).
3 Subsection 110.6 (2.1) of the Act.
4 The will of Mr. Anyman should provide that his shares are left to his wife.
5 The lesser of the ACB, PUC or the FMV.
6 Subsection 85(1) of the Act.
7 Section 51 of the Act.
8 Section 74.1 and following of the Act.
9 Form T2057 (Federal) and TP-518 (Quebec).
10 Subsections 248 (1) and 110.6 (2.1) of the Act.
11 ($1,800,000 X 24.1%) + ($700,000 X 32.12%). We assume that the tax rate of the dividends was 32.12% throughout the period of 1998-2005 (current rate).

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