Facilitating the Business Transfer through an Estate Freeze

By Natasha Girouard

The business owner often contemplates over a number of years the idea of transferring his enterprise to his children. In some cases, the increasing serious and constant implication of the owner's children in his business will lead him to believe that proper preparation and cooperation from specialized professionals will ensure a progressive transition and a successful transfer of the company.

Business owners wishing to undertake a transfer of a business, are strongly recommended to involve a "coach" or industrial psychologist in order to assess the abilities of the family members in taking over the business. Thus, if an aspect crucial for the business to run properly is not a strength of one or more family members, a third party (key employee) could be employed in order to ensure the transfer will be successful.

The estate freeze technique has been developed to facilitate the transfer of a business to the next generation. An estate freeze consists of a series of transactions by which the participating shares of a company are exchanged for preferred shares. The preferred shares have a determined redemption value so that any increase in the future value of the company will benefit the person or group of persons designated by the author of the estate freeze.

An estate freeze is usually undertaken as part of a larger estate plan that takes into account family, financial, legal and tax matters.

Objectives of the Business Owner

The business owner's objectives in undertaking an estate freeze are the following:

i) to minimize the tax consequences of his death in respect of the shares he owns in the company. The Canadian tax laws provide that when an individual passes away he is deemed, immediately before his death, to have disposed of his capital assets and to have received proceeds equal to their fair market value. The result of this deeming provision is generally an immediate tax liability based on the capital gain resulting from the accrued value of his capital assets[1]. The estate freeze assists in limiting the increase in value of the shares owned in the capital of the company

[1] This tax result can be deferred for a few months or years if the capital assets are irrevocably transferred to his spouse upon his death (common law spouse, married or in a civil union).

Natasha Girouard - Notary, D. Tax., Partner – Telephone: (514) 397-6734 - Email: jdupuis@bcf.ca

while allowing the business owner to preserve the accumulated value in such shares and earn a return on his investment;

ii) to gradually integrate and provide incentives to the family members in the shareholding of the company. The children's involvement and leadership in the business not always being the same, incentives could be provided by taking this situation into account. Frequently, some of the business owner's children demonstrate and express their interest in taking over the business, while others are not sure whether they want to become involved in the company;

iii) to keep control of the business for as long as he continues to hold shares in it. It is important for the founder to protect his investment while ensuring, among other things, that the business profits will be used to increase the company's value and also to generate a reasonable return on his investment;

iv) to limit the need for financing by the children. Thus, buying out the owner's interest could be done gradually based on the future profits generated by the company; and

v) to protect the patrimony of the business, in that the owner ensures that none of his children's potential financial problems may jeopardize the financial health of the business.

Estate Freeze Techniques

Setting up the estate freeze will permit a transfer of wealth since any future increase in value of the business (participating shares) will, directly or indirectly, be handed to those individuals who will take over the business. The transfer of control will be completed several months or years later when the investment of the company's founder will be fully reimbursed.

The first step will consist in "freezing" the value of the participating shares held by the company's owner by exchanging them for non-participating shares[2]. Upon freezing the participating shares, new multiple-voting shares will be issued to the owner and new

[2] The tax authorities have determined the requisite characteristics of the "freeze shares" in order to avoid all potential negative tax consequence from such transaction, including, that the shares must be redeemable at the option of the shareholder at the fair market value of the exchanged shares, that they be non-participating and have a priority in case of liquidation or dissolution.

Natasha Girouard - Notary, D. Tax., Partner – Telephone: (514) 397-6734 - Email: jdupuis@bcf.ca

participating shares (called "common shares"), having nominal value, will be issued to the next generation, either directly to the individuals or by means of a trust.

In order to provide greater flexibility to the author of the freeze, it is advisable to establish a trust for the benefit of the author of the freeze, his spouse, those of his children involved in the business along with one or more key employee(s), if required. As a result, some uncertainties regarding this transaction disappear.

Indeed, the author of the freeze is often uncertain as to appropriate time to implement the freeze. He may be concerned about the future value of the business. The difficulty in choosing the time to proceed with the freeze involves reconciling:

(a) the desire to establish the freeze as early as possible in order to maximize the related tax benefits, with

(b) the desire to avoid effecting, prematurely this operation which could reduce the standard of living of the author of the freeze. The risks linked to a premature freeze are greater when the author's assets are mostly made up of the company's shares, or when his assets are not diversified. In the same way, a freeze may be done prematurely if it is established in favor of inexperienced or ill-prepared beneficiaries.

Finally, identifying the beneficiaries of the freeze and determining the proportions of the shares that each beneficiary is to receive are also sources of uncertainties.

Use of a family trust

A family trust is administered by one or more trustees in favor of the beneficiaries. It is recommended that the deed constituting the trust is drafted in order to allow the trust to be administered in a flexible manner by the trustees. The Civil Code of Quebec provides that a trustee who is also a beneficiary of the trust cannot act alone and that he must act together with at least one "independent" trustee, (i.e. a trustee who is neither a beneficiary nor a settlor of the trust).

The beneficiaries of the trust do not have to intervene in the trust deed and, in fact, they do not even have to be informed about the existence of the trust. At the time of creation of the trust, the settlor will establish a list of identified or identifiable beneficiaries. In the case of a discretionary trust, the trustees will sometimes have the power to determine,

Natasha Girouard - Notary, D. Tax., Partner – Telephone: (514) 397-6734 - Email: jdupuis@bcf.ca

from the list of beneficiaries enumerated in the trust deed, who will be receiving the trust's revenue and capital, and in what proportions.

A corporation may also be a beneficiary of a trust, which provides a good potential tax deferral plan. A dividend declared on shares held by a trust could be attributed to a corporate beneficiary of the trust. Since certain types of revenue maintain their tax characteristic (such as a dividend), a dividend attributed to the corporate beneficiary of the trust could be received tax-free since it would continue to qualify as an intercorporate dividend. Tax would only be payable by the corporation's shareholder when the dividend is paid out by the corporation[3].

On the 21st anniversary of the trust's creation, the trust is deemed (for tax purposes) to have disposed of all of its assets at fair market value. In order to avoid this deemed disposition rule (and therefore a potential tax liability), we may undertake a reorganization or liquidation of the trust. A distribution of the trust's assets prior to this deemed disposition date would allow the transfer, on a tax rollover basis, of the trust's assets to one or several of its beneficiaries and therefore would avoid the tax resulting from this deemed disposition.

Benefits of using a Trust

Flexibility in attributing the shares

The use of a discretionary trust in the context of an estate freeze allows for the gradual transfer of ownership between generations (and/or key employees). While the children of the author of the freeze are still young, or studying at school or even in the case where they work in the business, it may be difficult for the author to decide the ultimate allocation of the company's shares among his children (or key employees).

Using a trust in the context of an estate freeze gives the possibility, provided the author of the freeze is a beneficiary of the trust, to reverse the freeze at any time. Thus, following an estate freeze, should the family or financial situation or tax laws change, the author can distribute all or part of the company's common shares to himself on a tax-free basis.

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[3] Subject to Part IV tax

Natasha Girouard - Notary, D. Tax., Partner – Telephone: (514) 397-6734 - Email: jdupuis@bcf.ca

Minimizing Tax at the Time of Death

An estate freeze limits the tax burden to be realized upon death of the author of the freeze. Following the freeze, the future growth in value will not be subject to tax at the time of the death of the author since the latter will no longer directly own any common shares.

Income Splitting with Beneficiaries

When a trust allocates revenue to one or several beneficiaries, the tax payable on this revenue will be payable by said beneficiaries. In general, dividends, capital gains and certain other kinds of revenue will maintain their favourable tax characteristics in their hands.

Since the tax rates in Canada are progressive, an individual with less revenue is taxed at a lower rate than the individual with more revenue. Therefore, when a trust receives a dividend from a corporation, it is advisable to have this dividend attributed to one or more beneficiaries who are of majority age and who fall in a lower tax bracket. However, the benefits of revenue splitting must be assessed in light of certain tax rules commonly referred to as the "attribution rules".

Multiplication of the Capital Gains Deduction

If the shares held by the trust qualify for the capital gains deduction[4], it is possible to multiply the number of available deductions. Upon an eventual sale of shares by the trust, it will often realize a capital gain. If the trustees make the appropriate tax elections, several beneficiaries, in addition to the author of the freeze, may be able to take advantage of their respective capital gains deductions. Thus, in the context of a sale of shares, the family unit may benefit from a significant tax saving.

Protection against Creditors

Where a trustee or beneficiary becomes insolvent, the assets held by the trust may not be affected by such situation because a trust has a separate and distinct patrimony. Obviously however, in the case where the trust distributes shares to an insolvent beneficiary, his creditors could then seize such shares.

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[4] The capital gains deduction is a tax benefit granted to each individual residing in Canada whereby $500,000 of realized capital gains (on certain particular assets) are free of tax.

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Protecting the Company's Liquidity

The discretionary trust is a very useful tool in order to extract the company's excess liquidity in order to protect it from a potential financial setback without any immediate tax consequences.

Additions to the Estate Freeze

In order to properly establish the rights and obligations between the various shareholders, it is essential to prepare and sign a shareholders agreement among the company's shareholders. As well, estate planning and planning in case of disability or incapacity of the author of the estate freeze should be carefully reviewed.

Conclusion

An estate freeze must be prepared in accordance with the particular facts of each case. In reality, applicable tax laws create certain traps that can have important consequences. Thus, it is recommended to consult with advisors who are close to the company's owner before implementing such a plan, including his accountant, financial planner and both legal and tax advisors.

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Natasha Girouard - Notary, D. Tax., Partner – Telephone: (514) 397-6734 - Email: jdupuis@bcf.ca