The Estate Freeze and Other Business Succession Strategies

“Everything freezes!”
Mr. Freeze, as portrayed by Arnold Schwarzenegger in *Batman & Robin* (1997)

Now that the new *Wills, Estates and Succession Act* 1 (“WESA”) has come into force, B.C. residents would be well advised to revisit and update their estate plans. For business-owners, the need to establish an effective business succession plan remains just as important after the introduction of WESA as before. This brief paper will highlight some of the key strategies available to ensure that the ownership and control of a privately held business is transferred to the business-owner’s heirs as efficiently as possible. The topics discussed here are truly just the tip of the iceberg. They are intended primarily to spark discussion and are not at all intended to be a comprehensive review of the subject. An effective estate plan needs to be adapted to the particular aims and circumstances involved in each individual case.

Having said that, most good business succession plans will, at a minimum, seek to accomplish the following two general goals:

1. achieving the best possible tax position for the business-owner and his/her heirs. In particular:
   a. minimizing the recognition of any “un-exempted” capital gains at the time of death;
   b. triggering the recognition of just enough capital gains to ensure that the business owner takes maximum advantage of the qualified small business corporation deduction and/or any unused losses; and
2. ensuring, to the greatest extent possible, that (i) the business will be effectively managed after death; (ii) the business-owner’s wishes with respect to the ongoing distribution of profits from the business are put into effect; and (iii) a fair and predictable mechanism exists to allow heirs to “cash-out” of the business if needed or desired.

We will address each of these goals in turn.

1. The Estate Freeze

   1.a. Minimizing the Recognition of Capital Gains at the Time of Death

   Most family businesses are owned through a private corporation. For the sake of simplicity, we will assume that we are dealing with an incorporated company (“OpCo”) throughout this paper.2

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1 SBC 2009, c. 13
2 That said, many of the goals discussed in this paper can be accomplished by similar means, using adapted business succession strategies, in the context of other business structures such as sole proprietorships, partnerships, etc.
Of course, with an incorporated business, the underlying business assets (e.g. equipment, lease rights, inventory, accounts receivable, goodwill, etc.) are owned by the corporation (OpCo), and will continue to be owned by the corporation after the death of the individual business-owner. What the business-owner (let’s call him “Arnold”) actually owns is shares in the corporation. It is these shares that will pass to his heirs on death (either pursuant to the terms of a Will governed by WESA, or pursuant to the terms of a trust). We will also assume that when the business was founded, Arnold subscribed for common shares in OpCo at a nominal subscription price, and that the value of the business has risen from $0 on day 1, to $1M on the day Arnold sits down to revisit and update his estate plan. Let us also assume that (though we won’t tell Arnold this) we know that Arnold will die 20 years later, at which time the business will have grown significantly and will be valued at $10M.

The *Income Tax Act*\(^3\) of Canada (“ITA”) provides that, on death, a taxpayer is deemed to have disposed of all of his/her capital property at fair market value.\(^4\) Thus, if Arnold does nothing and if the value of OpCo grows to $10M at the time of Arnold’s death, then Arnold will be deemed by the ITA to have disposed of the shares in OpCo at the fair market value of $10M. Arnold’s estate will recognize a capital gain of $10M. Therefore half of this gain, $5M, will be added to Arnold’s income in the year of death and the taxes payable on this income will need to come from the estate. In a worst-case scenario, if the estate does not have the liquid funds to pay these taxes, it may become necessary to sell the business (or take out a significant loan secured by the business) in order to pay. Even if Arnold’s estate is able to pay the tax, he has still missed out on an opportunity to defer a significant portion of that tax through a transaction called an “estate freeze”.

The purpose of an estate freeze is to “freeze” or fix the present value of the business in the hands of a first generation business-owner so that future growth will flow to his heirs. In the context of an incorporated business, such as the one owned by Arnold, the broad strokes are as follows:

1. Arnold gives up his existing common shares in the company (these will either go back to OpCo, or may alternatively end up in the hands of a holding company, depending on his tax goals);
2. Arnold will receive preferred shares in OpCo (or in the new holding company). These preferred shares will be redeemable and retractable, with a redemption price equal to the present value of OpCo. The redemption rights attached to these preferred shares will rank in priority to the participation rights of common shares in OpCo;

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\(^3\) RSC 1985, c.1 (5th Supp.)
\(^4\) ITA s.70(5)
3. OpCo will then be free to issue new common shares (the “growth shares”) to Arnold’s desired “heirs”.\(^5\) These common shares can be issued for nominal consideration without adverse tax consequences since, at the time of issue, the preferred shares have captured all of the present value of OpCo. The new common shares are often placed into a family trust, administered by Arnold. There are a variety of benefits to using a family trust in this way – not least of which is the fact that it ensures that Arnold, as trustee, will retain voting control of OpCo during his lifetime.

The end result of the estate freeze, from a tax perspective is as follows:

1. if done properly, there will be no capital gain recognized at the time the estate freeze is effected (or alternatively, if Arnold wants to recognize a gain, he will have control over how much of a capital gain is recognized);
2. at the time of Arnold’s death, a capital gain will be recognized in respect of the value of the business that has been frozen/fixed in the preferred shares – i.e. in respect of the $0 to $1M portion of growth. Therefore a $1M capital gain will be recognized and half of this gain ($500,000) will be added to Arnold’s income in the year of death; and
3. the growth of the business that has occurred from the time the estate freeze was effected to the time of death will not be recognized until the family trust disposes of the new common “growth shares"\(^6\). This will likely entail the deferral of a $9M capital gain for many years, perhaps decades.

There are three provisions of the ITA that are commonly used to ensure that no capital gain is recognized at step 1. above, i.e. when Arnold’s common shares are transferred to OpCo (or to a holding company):

- Section 85 Transfer of Eligible Property: s.85 permits a taxpayer to transfer “eligible property”\(^7\) to a Canadian corporation in exchange for shares in the corporation and to agree upon a deemed consideration amount for tax purposes. The taxpayer and the corporation must file a joint election (Form T2057) setting out the agreed amount. Subject to certain exceptions, the deemed amount may be anywhere between the adjusted cost base of the property transferred by the taxpayer and the fair market value of such property.

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\(^5\) Since these shares are issued during Arnold’s lifetime, the new common shares will not pass pursuant to Arnold’s Will (or on intestacy if there is no Will). Therefore the “heirs” are not really heirs in the strict legal sense.

\(^6\) or until the trust is deemed to have disposed of the shares, pursuant to the 21-year rule.

\(^7\) This generally includes capital property (but not real property owned by a non-resident, unless the non resident uses such real property in a business carried on in Canada), “eligible capital property” (e.g. goodwill), and inventory (but not real estate inventory).
• Section 86 Transfer in course of Reorganization: s. 86 may be used, in the course of a
corporate reorganization, to defer recognition of capital gains (or losses) where a
shareholder transfers all of the taxpayer’s shares of a particular class and receives
consideration that includes new shares in the company. No election is required.

• Section 51 Share Conversion: s. 51 may be used to defer recognition of capital gains (or
losses) when a share, bond, debenture, or note of a company is converted into (other)
shares of that company. No election is required.

Deciding which of the 3 provisions to rely on in any given circumstance involves a myriad of
considerations that go beyond the scope of this paper. Additionally, an estate freeze must be planned so
as to avoid unwanted effects of the various “attribution” and “conferral of benefit” rules contained in
the ITA8. Suffice to say, the decision as to precisely how and when to effect an estate freeze should be
made in close consultation with estate planning and tax professionals.

1.b Triggering the Recognition of “Just Enough” Capital Gains – Crystallization

In certain circumstances, it may be desirable to trigger (“crystallize”) a partial capital gain in
conjunction with an estate freeze. This may be the case for example where the taxpayer has unused
losses for the year or where the taxpayer wants to ensure that he/she makes use of the $800,000
“qualified small business corporation” (QSBC) lifetime capital gains exemption. The s.85 election
discussed above can be used to elect a deemed consideration amount in respect of the transfer of a
business-owner’s common shares back to OpCo (or to a holding company) that is somewhere between
the adjusted cost base of the shares and the fair market value of the shares.

Before deciding to proceed with a crystallization transaction, business-owners should take care
to ensure that the business in question qualifies as a QSBC and that the transaction makes sense in the
broader context of their tax position.9

2. Shareholder’s Agreements

Ensuring that the shares in OpCo are transferred to Arnold’s heirs in a tax efficient manner is
only half of the story. Because of the importance of inter-personal relationships in the management of
privately held corporations the death of a first generation business-owner will usually constitute a major
shift in the ongoing management of the company. When voting control of the company passes to heirs

8 Including for example, the attribution rules at ss. 74.1 to 75, and the conferral of benefit rules at 85(1)(e.2), 86(2),
and 51(2).

9 To name just one potential danger, the alternative minimum tax provisions of s.127.5 to 125.55 may operate to
negate the usefulness of a crystallization transaction where the taxpayer has little or no other income for the year.
or trustees the potential for uncertainty and conflict among heirs arises. For this reason it extremely important to ensure that a plan is put in place to minimize or provide a mechanism for the resolution of any points of conflict. A thorough shareholder’s agreement is the lynchpin of any such plan, and just as much care and thought should be invested in the creation of an effective shareholder’s agreement as in the creation of a Will.

Shareholder’s agreements must always be tailored to the particular circumstances of each individual business-owner, but in general they should, at a minimum, address the following issues:

1. how will the company be governed, and who will sit on the board of directors?
2. Who will manage the day-to-day operations of the company, or how will such persons be selected?
3. Will some of the heirs be compensated as employees, in addition to any compensation they receive as shareholders? How will salaries or other forms of remuneration be set?
4. How will profits of the company be distributed among the shareholders – i.e. in what percentages and at what intervals?
5. If one of the shareholders wishes to exit (either because a conflict has arisen, or simply because they need liquidity), what rights do they have to sell? Most shareholder’s agreements prohibit the transfer of shares without approval from the other shareholders. It is common to include some variation of the following limited rights to sell:
   (a) Right of First Refusal – i.e. the departing shareholder may market his/her shares to third parties but cannot complete any sale to a third party without first offering his/her shares to the other existing shareholders at the proposed price;
   (b) Piggy-back Rights – i.e. the right of the other existing shareholders to hold up any sale to a third party unless the third party also buys the other existing shareholders’ shares at the same price;
   (c) Draw Along Rights – i.e. the right of the departing shareholder to force the other existing shareholders to sell their shares to a third party buyer who wishes to purchase all, but not less than all, of the shares in the company (usually associated with a Right of First Refusal);
   (d) Shotgun Clauses – i.e. the right to invoke a sales procedure which requires the other existing shareholders to either buy the triggering-party’s shares at a price determined by the contract or to sell their shares to the triggering party at that price.
6. What happens if one of the heirs/shareholders passes away? Can he/she leave his/her shares to heirs of his/her own? Should the company be required to buy the shares? This issue will be particularly important if the heir in question is involved in the active management of the business.

7. If a conflict arises, what procedure will be used to break the deadlock or resolve the dispute? It may be desirable to refer certain types of disputes to arbitration.

By addressing these issues in a binding shareholder’s agreement (and by stipulating in the contract that any new shareholder must agree to be bound by the agreement before receiving his/her shares), a business-owner can ensure that he/she creates an important degree of legal certainty for his/her heirs. Failing to address these kinds of issues in a binding shareholder’s agreement increases the risk that heirs will become deadlocked and will feel forced to fall back on the general remedies available to shareholders in court, such as the oppression remedy or the ability to seek a winding-up order.

Conclusion

While it is easy to focus in on the Will when creating the estate plan, business-owners should take care not to overlook the business succession strategies that may be available to maximize tax efficiency and to minimize uncertainty and conflict among their heirs. Most of these strategies involve transactions and instruments that must be put in place during the business-owner’s lifetime and cannot be adequately addressed by the Will.

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10 If the company is required to purchase the shares, it may be desirable to obtain life insurance for the shareholder, naming the company as beneficiary – in order to ensure that the company has the funds required to purchase the shares if required. Alternatively, the company may be able to finance the purchase by way of a loan, or the purchase price may be made in installments.

11 Business Corporations Act, SBC 2002, c. 57 (“BCA”) at s. 227

12 BCA, supra at s. 324