

The big freeze

A Grant Thornton white paper for privately held businesses

Estate freeze/re-freeze strategies for the down market.

Freeze. Peter Lorre knew good advice when he heard it—usually while staring down the business end of Bogie’s heater.

It may be good advice for you, too, if the current economic downturn has you and your business feeling under the gun. We’re talking “estate freeze” here, a measure often taken to defer the tax liability associated with growing assets, but that also has significant potential as a financial planning strategy.

The economic downturn has spelled trouble for financial entities across the board. From banks to brokerages to businesses—including privately held businesses—market volatility, credit crunch pressure and consumer caution have hit hard. And some of the investment



vehicles most important to business owners—family trusts, holding companies, securities portfolios—may be heavily impacted, not to mention the potential loss of value in the business itself.

But as bad as the news may be, it may not be all bad. A market downturn, even one as serious as we're now seeing, presents opportunities for savvy financial planners, and the potential of the estate freeze—not just as a simple tax mitigator, but as a flexible and multi-purpose succession and estate planning tool—may be one overlooked thread in that silver lining.

What is an estate freeze, exactly?

When someone passes away, there is a deemed disposition, at fair market value (FMV), of all capital property owned by that person on the date of death (except where property passes to a spouse or common-law partner). It's at this point that the tax implications can be severe if no advance planning has been undertaken. If an individual's assets are expected to increase in value over time, those assets can be transferred to a holding company, converted into shares and frozen at their current market value, locking in not only that value, but also the tax liability that will be triggered upon the owner's death. Those shares are preferred shares with a redemption value equal to their current market value, while new growth shares are generally subscribed for by family members or a family trust. If no planning is done, however, the person's ultimate tax liability will grow unchecked, particularly if the assets continue to grow substantially in value.

The desire to freeze asset value to limit and defer future tax liability is the most common reason for an estate freeze, but in the current economic atmosphere, where so much seems so imminent, this strategy may not be on the front burner for many business owners—bad news, bad feeling and the fear of bad times, rather, are the currency of the day. The fact is, however, that not only can an estate freeze be an excellent manoeuvre to reduce and defer impending tax liabilities, but a well-considered re-freeze strategy, in the right circumstances, can turn the downturn to your advantage. (Please note that if you're taxable in a jurisdiction outside Canada, the following strategies may not be appropriate.)

Taking advantage of the market when it's down

There are, of course, occasional advantages to freezing assets at a higher value, say if all the shares were going to be redeemed at that higher value before death—used as a retirement income, for example. This is known as a wasting freeze. There are also, however, several situations in a down market where an estate freeze—or re-freeze—is an excellent idea.

Freeze

If you're the owner of a privately held business and have never previously considered an estate freeze, current low business values make this an excellent time to do so. When you fix the value of business or investment assets—company shares, real estate, securities—the presumption is that their value will continue to increase, but the tax liability on death will remain the same. Not only does this defer significant amounts of tax during the lifetime of the freeze, it provides certainty regarding the tax that will be owed on the owner's death.

The creation of a family trust is often part of an estate freeze and is a common and effective estate planning tool for privately held businesses. When assets are converted under the freeze to preferred shares in a new holding company, new common shares, which become the growth shares, are then created and issued to a family trust. If, for example, after 15 years the company is worth \$10 million and the original preferred shares were frozen at \$1 million, the common shares are worth \$9 million. Assuming the next generation will eventually receive the common shares, the freeze has effectively deferred and redistributed the tax liability on that \$9 million of value.

Re-freeze

But what if the value of the company actually decreases after the date of the freeze? This is a key strategic consideration for businesses that already have a freeze in place. Assume you have an investment company that was frozen in the past few years while businesses and markets were still in bull mode, but now, due to the recent market turmoil, the value of the company is now less than it was on the date of the estate freeze. This presents an excellent tax planning opportunity: The preferred shares can be "refrozen" at the lower current value, and the future up-tick in value passed to the growth shares. As the new preferred shares will now have an even lower fixed value, the tax liability upon death will again be reduced. This increases tax savings even further and offers greater asset retention to your heirs at a relatively low implementation cost.

Income splitting

The opportunity for income splitting between family members is another excellent reason for implementing an estate freeze—and in the right circumstances, a re-freeze. When a freeze is initially put in place, the future value growth of the company accrues to the common shares of the company, which are typically issued to family members either directly or indirectly through a family trust. It's the family trust model, if carefully structured, that is most

An estate freeze provides certainty regarding the tax that will be owed on a business owner's death.

advantageous and flexible because it allows income splitting between family members, which can mean substantial tax savings for the family as a whole.

What happens, though, when a company's value declines following a freeze? In this case, a re-freeze can maintain the effectiveness of this strategy. To preserve the value of the preferred shares, the payment of dividends on common shares is prevented where the value of the company would be reduced below the freeze value as a result of the dividend. Where income splitting has been achieved via the payment of dividends on common shares held in a family trust, and the value of the company has sunk below the freeze value, the ability to income split may be at risk. A re-freeze at the current lower value will allow the income splitting to recommence sooner than if the original higher freeze value were left in place.

Putting the (re)freeze on the 21-year rule

Many existing Canadian family trusts are currently approaching the point where the "21-year rule" will kick in, a tax law which forces the taxation of the accrued value in a trust's assets every 21 years. If the trust assets have not been distributed to its beneficiaries within 21 years of its inception, the trust will be taxed as if the assets had been sold at their fair market value. This can result in an unintended tax bill. Using the example mentioned earlier, if after 15 years the common shares of a company are worth \$9 million and are held in a family trust, that \$9 million, plus any new growth value, must be distributed within 6 years, or the trust will have to pay tax as if the shares had, in fact, been

sold. This is where an estate re-freeze may be an excellent strategy. If the trust's common shares are frozen at their current fair market value of \$9 million, new common shares—and a new family trust (perhaps now intended for grandchildren)—can be created. The clock on the 21-year rule can be reset on the new trust, and the tax liability for whatever growth would have accrued in the next six years can be deferred.

Some business owners may even want to develop a strategy of implementing a re-freeze of common shares at regular intervals, every 5-7 years, for example, with the aim of keeping the amount of value that must ultimately be distributed to beneficiaries, as per the 21-year rule, at a more manageable level. Limiting that value while letting new value accrue for a longer time in a new trust—and under trustee control—has obvious risk management benefits and provides greater certainty of succession for a family business.

A measure worth taking

A careful assessment of current needs, future plans and financial facts is key to the effective implementation of an estate freeze or re-freeze strategy. The upsides are evident, but one downside of freezing at a lower value, for example, is that the preferred shareholder's equity in the company is now also at a lower amount; is that amount enough for that person's expected future needs? Timing of the freeze or re-freeze with respect to the owner-manager's life expectancy is important, but given the potential tax and estate planning advantages, it's certainly worth investigating.

Family business succession

As part of an overall succession planning strategy, a carefully structured estate freeze can be a very effective way of directing new business growth into the next generation, addressing issues of future ownership, management, inheritance and business legacy. For example, parents may have clear ideas about which children might be best suited to certain aspects of the business—or, for various reasons, which may not be suited to the business at all, but for whom other assets might be set aside. By carefully freezing assets and creating one or more family trusts, not only can numerous tax benefits be realized, but real decisions can be made and managed as to how the family business will be continued in posterity.

This is why the family trust model can be preferable to issuing shares to individuals. The owner(s) of a privately held business may be amenable to giving up the future growth in the business, but rarely will they want to give up the control. Since family trusts are almost always discretionary, the trustees, as opposed to the beneficiaries, ultimately control the shares and income distributions.

Value in the current market: Is this really a good time to freeze?

Privately held business owners who have not considered valuation issues for some time may want to ask themselves some key questions: "What is the current value of my business?" "Is that value right for implementing a freeze or a re-freeze?" "Do current conditions make this a particularly good time for this strategy?" And most importantly, "Is this the right strategy for me, my future and the future of my business?"

Placing a value on your business can be a complicated exercise. In the case of a freeze strategy where value is determined in a "notional market" (the hypothetical market in which the FMV of a business is set), it's important that a thoroughly documented valuation analysis be completed. The CRA

A re-freeze that creates a new family trust can "reset the clock" on the 21-year rule.

has experienced valuers on staff who will probably review the assumptions and calculations behind your determination, so making sure that your valuation report is prepared by a qualified business valuator will assist in answering queries and mitigating problems.

Each business (even within industries) is different, with often distinctive revenue and expense characteristics, and Chartered Business Valuators have different ways of determining value based on these factors. Initially, valuers tend to use future cash flow approaches to measure value. Where no transaction data is available to develop expected rates of return, they often use a “build-up” method to determine an appropriate capitalization rate, starting with a “risk-free” rate and adding on risk points related to the industry, the investment cycle and the specific business. In some cases, valuers will use asset-based approaches as their best estimate of value because the business has not been able to generate sufficient profits for an investor to earn the expected rate of return.

The issue of business valuations has increased in complexity along with the complexity of modern business, and judgment calls with respect to expected earnings and rates of return are not done in isolation. To arrive at an accurate, reasonable and defensible valuation, business operations (financial, production, and marketing) must be considered, as well as the industry and the general economy. The point is, it’s crucial that you find an experienced, qualified

valuator who will use the method most appropriate for your business. Only then can you decide if the many potential benefits of an estate freeze can be realized for your business.

Benefits of freeze/re-freeze strategies in down market

Freeze	Re-freeze
Reduce tax liability on estate value at shareholder's death.	Lower tax liability on estate value still further.
Defer tax burden to next generation.	Help retain income splitting ability.
Enable income splitting between beneficiaries of a family trust.	Restart the clock on 21-year rule with new family trust.

Spin the downturn in your direction

The market downturn, of course, means varying degrees of trouble for just about everybody, but where the bee stings, the balm soothes; while low values for private companies are negative in terms of net worth, they offer real, positive opportunities in terms of both tax and estate planning. This is an excellent time for privately held businesses to re-evaluate their strategies in these areas with the potential advantages of an estate freeze—or re-freeze—in mind. And if the circumstances are right, now is the time to act.

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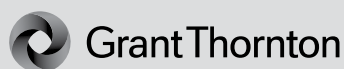
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