BMO Nesbitt Burns

August 2021

Financial Insights

from Quinn+Cardy Wealth Management
of BMO Nesbitt Burns

Business Owners: The Estate Freeze

Many business owners continue to be challenged by current economic conditions. During these times, there may be a potential opportunity if you are looking to plan for your business' eventual succession. If the current market situation has temporarily caused the value of your business to decrease, it may be an appropriate time to consider an estate freeze.

An estate freeze locks in ("freezes") the value of your current interest of your business today, allowing you to pass along any future growth in the business' value to another party.

How is this done?

There are various ways to freeze an estate. A common situation is where a business owner owns all of the shares in an incorporated business, such as common shares with voting rights. The owner identifies a successor(s) for the business, often the next generation. To complete the freeze, the owner has the company redeem his/her shares and, in exchange, the company issues new preferred shares with voting rights. These preferred shares have a fixed redemption value equal to the common shares that were just redeemed. Therefore, there are no immediate capital gains tax consequences from this exchange.

At the same time, the company issues new common shares to the successor(s) with no value. Any future growth in the company's value would then be associated with the common shares and not the preferred shares. In order for the owner to remain in control, the common shares could have voting rights, but not enough to outvote the preferred shares.

An estate freeze can also be done through a holding company or a trust, which may be used if beneficiaries are minors.

What are the benefits?

Facilitates better planning — By freezing the value of the business, the owner freezes potential capital gains upon the sale of the business. The business owner may then be able to better plan for the tax liability, knowing that it won't grow over time.

Locks in the business' sale price — During the freeze, the owner may also set the price that the future owners will have to pay for the business. Future owners may then be able to better plan for the purchase.

Provides potential tax-saving opportunities — If successor(s) have a lower marginal tax rate, an estate freeze may offer income-splitting opportunities with adult children. If beneficiaries decide to sell their own common shares in the company for a gain, they may potentially be able to use the lifetime capital gains exemption (LCGE), currently $883,384 for 2020 (if the business is considered a qualified small business corporation). A freeze also "locks in" the amount of assets subject to probate (in provinces where applicable), if the business may eventually be transferred at death.

Despite the benefits, there may be good reasons to avoid an estate freeze. If a business is not ready to identify its successors, there may be risks associated with this arrangement. As well, if a business' growth potential is significant, locking in a sale price today may not be the best strategy.

As always, please consult with legal and tax specialists for support as you consider your business' succession plan.

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