

---

## **BUSINESS RESTRUCTURING DURING COVID-19: ESTATE FREEZES**

---

*By Nancy E. Claridge and Luis R. Chacin\**

### **A. INTRODUCTION**

The economic fallout of the COVID-19 pandemic will leave very few businesses unscathed. With some businesses seeing their revenues for March, April and at least part of May dropping down to near zero, short-term working capital concerns have likely been top of mind over the past several weeks, with business owners carefully evaluating the financial support programs available (or soon to become available) by federal and provincial governments, and possibly negotiating existing loan agreements at risk of default. The COVID-19 pandemic has also caused a significant drop in the market values of almost all asset classes, including real property and private equity.

However, the COVID-19 pandemic may also provide an opportunity to consider fundamental changes to the corporate structure of a business to manage its medium and long-term viability. For example, lower asset values may provide a timely opportunity to consider estate freezes.

### **B. ESTATE FREEZES**

A commonly used tool in succession planning is the “estate freeze” (or “re-freeze”, as a follow up to an estate freeze). Generally speaking, an estate freeze is the process of changing the share ownership structure of an incorporated family business so the owner’s younger family members may take advantage of the future growth of the business, without taking immediate control, and also take over the tax liability from

---

\* Nancy E. Claridge, B.A., M.A, LL.B., is a partner at Carters practicing in the areas of business law, real estate and wills and estate. Luis R. Chacin, LL.B., M.B.A., LL.M., is an associate at Carters Professional Corporation.

capital appreciation going forward. Because the current value of the business is “frozen” at current market levels, the business owners’ tax liability is also limited by realizing a capital gain now while maintaining control over the business until the owner is ready to retire. If the intended successors are too young to own shares in the business, the estate freeze may be done by transferring the business interest to a family trust.

By realizing a capital gain on a business that is expected to continue to grow over the next few years or decades, the owners can maximize the lifetime capital gains exemption (“LCGE”) which, in 2020, could exempt from tax \$883,384 per taxpayer on capital gains realized on the sale of shares of a qualified small business corporation, provided 90% or more of the corporation’s assets are “active business assets” and not passive investment of the corporation (*e.g.* securities, rental properties, excess cash savings).<sup>1</sup> The process of removing non-qualifying assets from the corporation, either by sale or transfer, in anticipation of a sale of the business to take advantage of the LCGE is typically referred to as a “purification”.

In addition to the LCGE, the capital gains that would have otherwise been realized upon the death of the owner, at least with respect to the value of the business, are also “frozen” in an estate freeze. The capital gains from the growth in the value of the business are deferred and will accrue to the successors, with the tax liability becoming payable in the future when the recipient younger generation is closer to retirement.

For example, the owner of a 20-year old incorporated family business now valued at \$2 million would generally implement an estate freeze by having the corporation exchange the owner’s common shares for preferred or special shares with a redemption value of \$2 million.<sup>2</sup> The preferred or special shares would be typically redeemed with funds generated from the business over several years. At the same time, the successors would be issued a new class of common shares at nominal value; however, several years later, when the business is worth \$4 million, this capital gain from the increase in the value of the business would be attributed to the new common shares issued to the successors, leaving the business-related tax liability of the owner’s estate, “frozen” at the \$2 million value from the time of the estate freeze.

---

<sup>1</sup> See Government of Canada, “Indexation adjustment for personal income tax and benefit amounts” (last modified 31 December 2019), online: <https://www.canada.ca/en/revenue-agency/services/tax/individuals/frequently-asked-questions-individuals/adjustment-personal-income-tax-benefit-amounts.html>. See also, “Government of Canada, “What is the capital gains deduction limit?” (last modified 21 January 2020), online: <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses/line-25400-capital-gains-deduction/what-deduction-limit.html>

<sup>2</sup> This exchange may be done through a reorganization under section 86 of the *Income Tax Act*, RSC 1985, c 1 (5th Supp) [ITA]; another option is by rolling over all the common shares of the owner to a holding company under section 85 of the ITA.

Other benefits of an estate freeze include encouraging the younger generation to commit to the family business with an incentive to work hard to preserve or increase the value of the business, providing an income to the owner while preparing for a future transfer of control over the business at a pace that works for everybody.

## C. CONCLUSION

Although there are many benefits to an estate freeze, it is important to note that there are a number of relevant considerations not discussed in this Bulletin that may suggest that other business restructuring options should be considered, depending on the specific circumstances of a business. It is also recommended that both accounting and legal advisors be consulted.