Transferring Your Business to the Next Generation

Entrepreneurs who have built successful companies often want to see their business passed effectively to the next generation. However, a sale or transfer of ownership of the business will generally trigger capital gains tax. If the value of the shares of your business has increased, you or your estate may be burdened with a substantial tax bill. The business may even have to be sold to cover the liability.

Family business owners could consider an estate freeze

A potential strategy used to transfer wealth or implement a succession plan, and to manage the tax liabilities on a transfer, is to freeze the value of your shares during your lifetime. An "estate freeze" allows you to fix the value of all or part of the capital gains accrued to date on the shares of your business. The future growth in the business is transferred to the eventual owners, typically your children. A depressed value of your business resulting from an economic slowdown may provide an opportune time to consider a freeze.

By limiting the tax liability on an appreciating asset in this way, your estate may avoid facing a potentially higher tax liability in the future, upon your death. Your estate's tax liability can be limited by the fixed present value of your "freeze" shares, and any future capital gains can be taxed in the hands of the new owner(s). Sufficient life insurance can then be obtained to cover your fixed death tax liability.

If your business is a Qualified Small Business Corporation ("QSBC"), an estate freeze may allow you to take advantage of the lifetime capital gains exemption for QSBC shares. [Note that this exemption amount increased to $971,190 in 2023, and will be annually indexed to inflation in subsequent years.] Any future growth in the value of the shares can be divided among members of your family, increasing the number of potentially available QSBC exemptions. It may also be possible to split income on the payments of dividends to your family members who would (directly or indirectly) hold shares of the corporation following an estate freeze, particularly where they are "actively engaged" in the business. However, in addition to the corporate attribution rules, the tax legislation includes other rules that can limit income-splitting with certain family members involving private companies. For more information, please ask your BMO financial professional for a copy of our publication, *Tax Changes Affecting Private Corporations: Tax on Split Income*.

Freezing your assets

There are various ways to accomplish a freeze, the most common being the owner of the small business corporation reorganizing the share structure of the existing company.

Here's how it might work:

Step 1: You exchange your existing common shares in the business for voting, redeemable, retractable preferred shares of the same value. This exchange can typically be completed on a tax-deferred basis, or alternatively, a capital gain can be realized to use any remaining capital gains exemption on qualifying QSBC shares.

Step 2: Create a new class of common shares to be purchased for a nominal amount by your children (or a family trust for their benefit). A trust might be used to hold the growth shares to provide flexibility and control – particularly when children are young or when direct ownership is otherwise undesirable.

The future growth in the business will accrue to the new common shares, and future capital gains tax liability will be deferred until these holders of the new common shares sell or otherwise dispose of their shares.

The benefits

An estate freeze can encompass the flexibility desired to meet your particular needs. Receiving preferred shares with voting rights means you can effectively retain control of your business. The preferred shares generally have a stated dividend rate to help provide retirement income, and you can redeem the shares over time for additional income. If you also want to participate in some of your company's future growth, you might choose to retain some of the new common shares for yourself.

As noted above, an estate freeze allows the deferral of taxation on future growth until the new common shareholders sell or dispose of their shares. In addition, if these shares qualify as a QSBC share at the time of disposition, it may be possible to shelter any future capital gains by accessing the available capital gain exemption of these shareholders, whether the shares are held directly or through a trust. For more information on the QSBC qualifying criteria, please see our BMO publication, *Tax Planning for the Family Business*.

Other considerations

The suitability of an estate freeze will depend on a number of factors, including the anticipated future health of your company, your financial position, and long-term objectives. If the value of your business isn't likely to increase significantly after the freeze, or if you will need cash and are planning to sell the business shortly afterwards, then an estate freeze may not be appropriate. Some business owners have regretted freezing their business too early in their lifetime.

You should also consider the costs associated with a freeze, such as valuation costs, accounting and legal fees, and the set-up and maintenance expenses of a trust. Careful assessment of your financial and lifestyle objectives, current net worth and cash needs, growth potential of your assets, and your future financial needs can help determine whether an estate freeze would be beneficial in your situation.

Due to the complexity of the relevant tax rules and the need to avoid any unforeseen tax pitfalls in implementing an estate freeze (such as income attribution, tax on split income, or alternative minimum tax), professional tax advice (as well as legal and estate planning advice) in the design and implementation of an estate freeze is required.

For more information, please speak with your BMO financial professional.

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