LEGAL BUSINESS REPORT | ALPERT LAW FIRM
THE TAX LAW PROFESSIONALS
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ESTATE FREEZE TRANSACTIONS

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on estate planning techniques for small businesses and their shareholders. Alpert Law Firm is experienced in providing legal services to its clients relating to estate planning, including the preparation of wills, deeds of gift, trust documents and all documentation required in connection with estate freezes and other tax, corporate and estate planning matters.

A. ESTATE FREEZES

An "estate freeze" is designed for tax purposes to freeze the current value of capital assets, such as shares in a corporation, investments, or real estate (which is used to earn income from a business or an investment). It is particularly attractive to undertake an estate freeze as early as possible in order to obtain a lower valuation of the current fair market value (the "FMV") of capital assets.

This estate planning technique may result in substantial tax deferral by significantly reducing the transferor's liability for capital gains tax as a result of a deemed disposition of capital assets, which occurs upon death (except in situations where the capital assets are transferred to a spouse or a spousal trust on a tax-free rollover basis at the transferor's adjusted cost base (the "ACB")). In addition, by freezing the value of the transferor's assets that will be deemed to have been disposed of upon death, the technique will reduce the amount of estate administration tax payable by the transferor's estate.

Unlike life insurance premiums, which must be paid annually to ensure sufficient liquidity to pay capital gains tax arising on a deemed disposition upon death, the cost of implementing an estate freeze is generally a one-time expense. However, a fixed amount of life insurance may be used in conjunction with an estate freeze to off-set the amount of any capital gains tax liability regarding the frozen capital property. In such an arrangement, the amount of life insurance would be based on the excess of the freeze amount over the ACB of the frozen capital property.

For example, assume a family business is currently worth $500,000 and an estate freeze is implemented that transfers the future growth in value of the frozen assets to the owner's children. As discussed below, the owner will still maintain control over the family business. If the family business is worth $1,500,000 when the owner

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dies, then the payment of capital gains tax on the $1,000,000 gain is deferred as a result of the estate freeze. The rate of inclusion in income is one-half for capital gains. Based on the current top marginal rate of tax of approximately 50%, the capital gains tax deferral on the $1,000,000 gain as a result of the above-mentioned estate freeze would be approximately $250,000.

Under the Income Tax Act (the "Act") there are three ways an estate freeze can be effected: (i) a share rollover under subsection 85(1), (ii) a share reorganization under section 86, and (iii) a share conversion under section 51. The Act also prescribes the precedence among these provisions, in the event that more than one is applicable to a fact situation. Subsection 86(3) of the Act states that, if subsection 85(1) of the Act applies, subsections 86(1) and 86(2) do not apply. However, subsection 51(4) of the Act, states that each of subsections 85(1) and 85(2) and section 86 takes precedence over subsections 51(1) and 51(2) of the Act. Therefore, the order of precedence is: (i) subsections 85(1) and 85(2); (ii) subsections 86(1) and 86(2); and (iii) section 51.

B. SUBSECTION 85(1) ESTATE FREEZES

An estate freeze using a holding corporation may be used for the benefit of adult children. Either assets or shares of a corporation may be transferred on a tax-free basis to a holding corporation by filing a prescribed election form within the prescribed time, pursuant to the provisions of section 85 of the Act. This transfer does not trigger any capital gain or any recapture of depreciation. In exchange, the owner receives redeemable, retractable, demand special shares from the holding corporation that are worth the current FMV of the assets or shares that are frozen. A price adjustment clause is generally used in this type of transaction to retro-actively adjust the FMV of the redemption price of the special shares in the event that the Canada Revenue Agency (the "CRA") successfully determines that the FMV is greater or less than reported. The special shares received by the transferor control the holding corporation by virtue of having the majority of the votes at meetings of the shareholders.

C. SUBSECTION 86(1) ESTATE FREEZES

Alternatively, an estate freeze may be implemented using the provisions under section 86 of the Act. Section 86 of the Act allows a tax-free rollover in the situation where, under a reorganization of the capital structure of a corporation, a taxpayer disposes of all the shares of any particular class of the capital stock of the corporation

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(the “old shares”) in consideration for which the taxpayer receives from the corporation other shares of the capital stock of the corporation (the “new shares”).

The section 86 rollover does not apply to: (i) the disposition of securities other than shares, such as bonds or other debt securities; (ii) the disposition of shares that do not constitute capital property of the shareholder; and (iii) dispositions by a shareholder of less than all of the shares of a particular class of the corporation’s capital stock.

The section 86 rollover occurs by operation of law under the Act and therefore, no election form needs to be filed with the CRA.

This type of rollover may be implemented by Articles of Amendment under the *Ontario Business Corporations Act* or the *Canada Business Corporations Act*. The rollover generally involves the re-classification of the common shares of a corporation into special shares by filing Articles of Amendment for the corporation and the transfer of common shares of the corporation on a tax-free basis in exchange for redeemable, retractable, demand special shares from the corporation that are worth the current FMV of the shares of the corporation. A price adjustment clause is generally used in this type of transaction to retro-actively adjust the FMV of the redemption price of the special shares in the event that the CRA successfully determines that the FMV is greater or less than reported. The special shares received by the transferor would control the corporation by virtue of having the majority of the votes at meetings of the shareholders.

In addition, a section 86 rollover is available where shares of a certain class are sold by the taxpayer to the corporation in exchange for shares of another class from the treasury. However, the share transfer agreement must reflect the intention of the parties to have section 86 of the Act apply to the transaction. Otherwise, the transaction will be deemed to take place under section 69 of the Act at FMV and it will not receive rollover treatment.

There are certain restrictions which may limit the effectiveness of the section 86 rollover. Namely, the effect of a section 86 rollover will be reduced in cases where the value of the new shares and the property other than the shares is less than the value of the old shares, and it is reasonable to consider the difference as being a gift to a person related to the taxpayer. In this instance, subsection 86(2) of the Act provides a formula, which determines the amount of the proceeds of disposition of the old shares and the ACB of the new shares received on the reorganization. The automatic application of this formula in the aforementioned circumstances may result in the triggering of a capital gain on the disposition of the old shares.

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D. COMMON FEATURES OF SUBSECTION 85(1) AND SUBSECTION 86(1) ESTATE FREEZES

Common features of estate freezes implemented under subsection 85(1) or section 86 of the Act are

(i) Adult children of the owner may purchase common shares of the holding corporation for a nominal value. Alternatively, the owner may purchase common shares of the holding corporation and gift them to the adult children by way of deed of gift. The deed of gift to an adult child, who is married, may contain provisions excluding both the capital of the gift and any income generated from the gift in calculating net family assets of the adult child and his/her spouse.

(ii) Dividends may be paid on the common shares to the adult children without any attribution of dividend income or any deemed receipt of interest income back to the transferor, thus permitting a fluctuating dividend to be payable on the special shares received by the transferor on the freeze.

(iii) The value of the special shares does not increase from the date of the estate freeze, while all the future growth of the holding corporation passes to the adult children by virtue of their ownership of the common shares. This transaction may considerably reduce the transferor's liability for capital gains tax at death. The common shares of the holding corporation have a nominal value at the time of acquisition and there may be significant capital appreciation in the value of these shares in the future.

(iv) Estate freezes for the benefit of minor children or grandchildren are also possible. However, the impact of tax on split income and income attribution rules must be considered regarding taxable dividends received by the minor children or grandchildren.

E. SECTION 51 ESTATE FREEZES

Alternatively, an estate freeze of the shares of a corporation may be implemented using the provisions of section 51 of the Act. Section 51 of the Act permits a tax-free rollover where the taxpayer exchanges convertible securities for shares of the same corporation. As an alternative to a share-for-share exchange rollover pursuant to

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section 86 of the Act, a corporation may reorganize its share capital by using section 51 of the Act to defer the realization of capital gains. This provision allows for a deferral of capital gains on a share-for-share exchange. As a result, the ACB of the exchanged shares will be the same as the ACB of the shares that were converted.

A section 51 rollover is available even if the terms and conditions of the exchanged shares do not provide a right of exchange or conversion. Subsection 51(1) of the Act may be used in cases where it is desirable to create two or more classes of convertible shares for the purpose of declaring different types of dividends on each class of convertible shares.

One of the requirements under section 86 is that all of the shares of a particular class of a corporation that are owned by the taxpayer must be exchanged for the new shares of the corporation. However, in order to obtain the deferral tax benefits of a section 51 share-for-share exchange, this is not necessary and the taxpayer is permitted to exchange a portion of his shares of a particular class of the corporation for the new shares of the corporation.

Another difference between conducting an estate freeze under section 51 compared to under section 86 of the Act, is that section 51 deems the exchange to be a transfer of property, not a disposition of property, for the purposes of corporate attribution rules. Therefore, under section 51, the taxpayer is not required to report a disposition.

One of the main disadvantages of conducting an estate freeze under section 51 of the Act is that non-share consideration may not be received on the conversion.

In the event that the transaction results in an indirect gift to a related person, whereby the value of the received shares is less than the value of the convertible property, subsection 51(2) of the Act will apply and override subsection 51(1) of the Act. As a result the taxpayer may be forced to recognize a capital gain on the conversion and to adjust the ACB of the exchanged shares accordingly.

Subsection 51(3) of the Act contains a provision whereby a paid-up capital deficiency on the exchanged shares will flow through to the shares received by the taxpayer as a result of the share exchange. This provision ensures that the share exchange will not result in any increase in the paid-up capital of the exchanged shares to which section 84 of the Act could apply. If section 84 of the Act did apply, the taxpayer would be deemed to have received a dividend.

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Subsection 51(4) provides that a section 51 share-for-share exchange will only apply to transactions where the provisions of subsection 85(1), subsection 85(2) or section 86 do not apply. Therefore, care must be taken when documenting the transaction to specify that the taxpayer intends that the share-for-share exchange is governed by section 51 of the Act.

F. ESTATE FREEZES TO TRANSFER REMAINDER INTEREST

Subject to the provisions of section 43.1 of the Act, a partial estate freeze may be used by a parent to transfer the remainder interest in real property to children while retaining the life interest for the benefit of the parent. Since the parent retains the life interest in the assets there is no change in beneficial ownership of the life interest and no resulting disposition of the life interest for capital gains purposes.

However, subject to the provisions of section 43.1 of the Act, the remainder interest in the property is deemed to be disposed of by the parent at FMV pursuant to section 69 of the Act giving rise to a capital gain, one-half of which is required to be included in the parent's income subject to tax in the year that the asset transfer occurs.

Usually an actuary is retained to apportion the FMV of the transferred asset between the life interest and the remainder interest. The younger the age of the parent at the date of the transfer, the greater the portion of the FMV of the assets that is attributed to the life interest and the lower the capital gain resulting from the disposition of the remainder interest to the children.

This type of freeze is especially attractive when the FMV of the frozen asset does not greatly exceed the ACB. When the transferor dies the remainder interest passes to the children without any disposition for capital gains purposes.

Pursuant to section 43.1 of the Act, a parent who disposes of a remainder interest in land while retaining a life interest in the land is deemed to have disposed of and subsequently reacquired, the life interest at its FMV at the time of the transfer. Therefore, the entire accrued gain in the land will be taxable at that time. Any gain in the value of the land after the division of the land into a life interest and a remainder interest is deferred, since a rollover is available under subsection 43.1(2) of the Act on the death of the life interest owner. The parent is deemed to have disposed of the life interest upon death at its ACB which would usually be equal to its FMV at the time of the division of interests and that amount is required to be added to the ACB of the land in the event that the surviving holder of the remainder interest and the deceased did not

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deal at arm's length. In the event that the value of the land has decreased since the division of interests, the surviving non-arm's length owner's ACB must be reduced by an equivalent amount.

Section 43.1 of the Act does not apply to Crown or charitable donations. Consequently, remainder interests in land can be donated to the Crown or a registered charity without triggering a disposition of the life interest. Section 43.1 of the Act does not apply to a transfer by a parent of a remainder interest in a qualified farm property to a child.

G. WASTING FREEZES

Under a wasting freeze, the freezor exchanges his or her common shares for non-participating, redeemable, retractable preferred shares of the corporation ("freeze shares") having a redemption value equal to the fair market value of the exchanged common shares. The exchange takes place on a tax-deferred basis using either (i) a share rollover under subsection 85(1) of the Act, (ii) a share reorganization under section 86 of the Act, or (iii) a share conversion under section 51 of the Act. New participating shares ("growth shares") are then subscribed for by the freezor's family members.

The corporation will from time to time redeem a portion of the freeze shares. The redemption gives rise to a deemed dividend equal to the proceeds of redemption less the paid-up capital of the redeemed shares. The freezor's interest in the corporation is slowly reduced, or "wasted away", resulting in little or no tax owing on his or her death from a deemed disposition of the freeze shares since the shares will be partially or fully redeemed. Wasting freezes are effective for the purpose of spreading the tax burden across the freezor's lifetime in order to make tax payments easier to manage, while providing the freezor with a steady cash flow so that the freezor's lifestyle can be maintained.

Prior to 2011, the wasting freeze strategy was especially favourable for taxpayers who controlled a corporation with balance available in its refundable dividend tax on hand ("RDTOH") account, since the dividend refund to the corporation under subsection 129(1) of the Act would, in many cases, exceed the personal income tax owed by the shareholder on the deemed dividend arising as the result of the redemption of the freeze shares. However, changes in the tax rates have reduced the attractiveness of the wasting freeze strategy as a tax planning tool for many high-income taxpayers.

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In 2018, the top marginal tax rate in Ontario on an eligible dividend is 39.34% and on a non-eligible dividend is 46.84%. The dividend refund rate in 2018 is 38.33%. With the tax rates on both eligible and non-eligible dividends exceeding the dividend refund rate, the benefits of using a wasting freeze as part of RDTOH planning have been largely eliminated in Ontario. Nevertheless, the wasting freeze strategy is still an effective option for a taxpayer, who needs steady income from a corporation, but wants to reduce or eliminate his or her tax liability arising from a deemed disposition of the shares on death.

H. SKINNY VOTING SHARES

As part of an estate freeze strategy, a separate class of voting, non-participating shares may be issued to the freezor for a nominal amount to allow the freezor to maintain voting control of the corporation. These shares are known as skinny voting shares, or thin voting shares. These shares have voting rights but do not have any rights to dividends or proceeds on windup, thereby avoiding value being attributed to the shares in the future. In an estate freeze where skinny voting shares are issued, the freezor maintains voting control of the corporation even if he or she redeems his or her freeze shares.

The valuation of skinny voting shares is dependent on the facts and circumstances of each case and some skinny voting shares may have value derived from a control premium if a hypothetical purchaser is willing to pay a premium for the voting control of the corporation. The fair market value of each class of shares is determined according to the rights and restrictions of each class, and voting control is a right that may have significant value. The estate planning objective of skinny voting shares is to find a strategy that that allows the freezor to maintain control without attracting too large of a control premium, which would partially water down an estate freeze.

The CRA has addressed the valuation of skinny voting shares several times. At the 2009 British Columbia Tax Conference, the CRA stated that “non-participating controlling shares have some value and may therefore bear a premium. However, in the context of an estate freeze of a Canadian-controlled private corporation, where the freezor, as part of an estate freeze, keeps controlling non-participating preference shares in order to protect his economic interest in the corporation, the CRA generally accepts not to take into account any premium that could be attributable to such shares for the purposes of subsection 70(5) of the Income Tax Act at the freezor’s death.”

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At the May 2009 Alberta CAs Roundtable, the CRA stated that where qualifying farm or fishing corporation shares are transferred to a child in an estate freeze transaction, a parent may retain voting control of the corporation by holding skinny voting shares. The CRA will consider these skinny voting shares to have a nominal value if they are issued as a part of an estate freeze transaction and their purpose is to protect the parent's economic interest in the corporation.

At the November 2009 Canadian Tax Conference, the CRA stated that it will ''play along'' with the view that the skinny voting shares have no premium value. The CRA referred to the classic movie *The Wizard of Oz* and stated that if the taxpayer never pulls back the curtain to reveal the *Wizard* (i.e a value of the skinny voting shares) then the CRA will proceed on the basis that the shares have no value. However, if the taxpayer pulls back the curtain to reveal the value of the voting shares (i.e. if the value of the shares is demonstrated in a legal proceeding or on a sale for proceeds), then the CRA will assess on that basis.

There is still uncertainty surrounding the treatment of skinny voting shares that were (i) not issued in conjunction with an estate freeze; (ii) sold or otherwise disposed of prior to the death of the freezor; or (iii) contributed to an alter-ego or joint partner trust such that subsection 70(5) of the Act no longer applies on the death of the freezor.

I. PARTNERSHIP FREEZES

A partnership freeze is a transaction where the value of certain assets is frozen through the use of a partnership. A partnership freeze is available where the estate freeze would have otherwise qualified as a corporate estate freeze. Partnership freezes are generally used when it is not viable to use a corporation for an estate freeze

J. ALTERING AN ESTATE FREEZE

Estate freezes are not irreversible. There are various ways you can alter an estate freeze, including: (i) an estate melt, (ii) an estate thaw, and (iii) an estate re-freeze. Before altering an estate freeze, you should contact a qualified legal professional to ensure that you choose the best method for the situation and to avoid triggering any unintended tax consequences, like a deemed dividend.

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(i) ESTATE MELT

A "melt" allows the freezor to access some of the appreciation of the corporation, not necessarily through growth shares, so that some of the future value of the corporation will accrue to the freezor while the legal structure of the estate freeze remains intact. There are several ways to conduct an estate melt, including: (i) increasing the salary or bonus paid to the freezor; (ii) increasing the dividends declared in favour of the freezor; (iii) increasing management fees paid to the freezor; (iv) increasing the interest rates paid on any notes the freezor took back as part of the initial estate freeze; and/or (v) redeeming the freezor's preferred shares in the corporation, provided that they are redeemable at the option of the freezor.

(ii) ESTATE THAW

A "thaw" goes one step further than an estate melt and alters the legal structure of an estate freeze. Consequently, the estate freeze is retroactively unwound with the result that the freezor returns to the same situation he was in before the freeze was implemented. The primary methods of achieving an estate thaw are as follows: (i) the freezor re-acquires the growth shares and (ii) the freeze shares are converted into growth shares.

(iii) ESTATE RE-FREEZE

Individuals who participated in an estate freeze during prosperous times may find that a recessionary period has eroded the value of the demand special shares received under the estate freeze. If so, the individual may consider undertaking a re-freeze of the estate at the lower FMV of the capital assets. This would allow a further reduction of the freezor's tax liability on death, including a reduction in estate administration tax.

In order to avoid conferring a benefit on other shareholders, the re-freeze could be structured so that the freezor is the sole shareholder at the time of the re-freeze. This could be accomplished if the other shareholders gift their shares to the freezor or if the corporation purchases their shares for cancellation for nominal consideration. Then, the freezor may exchange all of his shares for new, demand special shares, redeemable at the current FMV of the corporation, and acquire new common shares for nominal consideration. The freezor may later elect to gift the new common shares to the previous shareholders but there must be no contractual commitment at the time of the re-freeze between the previous shareholders and the freezor requiring him to do so.

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Provided that the decrease in value of the preferred shares in this type of transaction is not the result of stripping corporate assets, the CRA has commented that it will not ordinarily consider a benefit to have been conferred on the common shareholders or the preferred shareholder.

The CRA has also commented that a benefit would generally not be considered to have been conferred in the event that prior to a re-freeze transaction, the common shares of the freeze corporation are sold at FMV to either the holder of the preferred shares or the freeze corporation, thereby resulting in only one shareholder, and new common shares are then issued to the former common shareholders. As a result, this will avoid any potential problem under the general anti-avoidance rule pursuant to the Act.

Caution must be exercised in structuring estate re-freezes, since the above-mentioned CRA comments are not binding on the CRA.

K. TOSI RULES RELATING TO ESTATE FREEZES

Effective January 1, 2018, the tax on split income ("TOSI") rules contained in section 120.4 of the Act were significantly amended to reduce or eliminate the ability of taxpayers to engage in income sprinkling. Prior to the new TOSI Rules, the CRA stated that an estate freeze transaction in which adult children over 18 years of age and/or a spouse benefited from income sprinkling did not run afoul of the Act. However, the new TOSI Rules extend to all individuals, including adult children and/or a spouse who are over 18 years of age.

Under the amended TOSI rules, in general, family members who receive shares but have not contributed to the business will be subject to tax at the highest marginal personal income tax rate on any dividend income received from the corporation. However, the amended TOSI rules will generally not limit the family members' access to the lifetime capital gain exemption, with one exception for minors.

For adult individuals, the definition of split income under the amended TOSI rules specifically exclude capital gains realized from the disposition of (i) qualified small business corporation shares; and (ii) qualified farming or fishing property. In order to obtain the lifetime capital gains exemption, the corporation must meet the "qualified small business corporation" test and the shares held by the child and/or spouse must be "qualified small business corporation shares". A corporation may be required to be

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purified prior to implementing an estate freeze transaction in order to qualify for the lifetime capital gains exemption.

However, for individuals under the age of 18, the capital gains from a sale of qualified small business corporation shares will only be exempt from the TOSI rules if the qualifying shares is transferred by the minor to an arm's length person. In the event that a minor disposes shares to a non-arm's length person, the capital gains realized from the disposition will be subject to tax at the highest marginal personal income tax rate and will not be eligible for the lifetime capital gains exemption unless another exception to the TOSI rules is applicable.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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