Estate Freezes: What, Why, When and How

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Estate Freezes: What, Why, When and How

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Lawyers who advise owners of closely-held corporations will be asked to assist in the implementation of a share value freeze for a client from time to time. The term "estate freeze" is often applied to this type of corporate reorganization, even though it may be undertaken for reasons other than estate planning. This paper explores the basic questions surrounding estate freezes and comments on some of the important legal, planning and tax considerations to keep in mind when embarking on such a project.

The type of planning which leads to an estate freeze is, unavoidably, multi-disciplinary. The lawyer will need to work closely with the client's other professional advisers -- most importantly, the client's accounting advisers. Indeed, it will often be the case that an estate freeze plan will be developed by the client's accountants and the lawyer will be called upon merely to prepare the necessary legal documentation. Even in such cases, however, it is important for the lawyer to have an understanding of the rationale for the various implementation steps. As well, the lawyer will need to be conscious of the estate planning and family law implications of the contemplated steps. A specialized corporate practitioner may need to consider enlisting assistance from lawyers working in these other focus areas to ensure that these considerations are properly addressed.

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Be aware that this paper only addresses Canadian corporate, tax and other legal considerations of an estate freeze. Clients with United States and other foreign connections (such as foreign citizenship, ownership of foreign-situs assets, etc.) will need specialized advice when considering an estate freeze.

1. What is an estate freeze and why implement one?

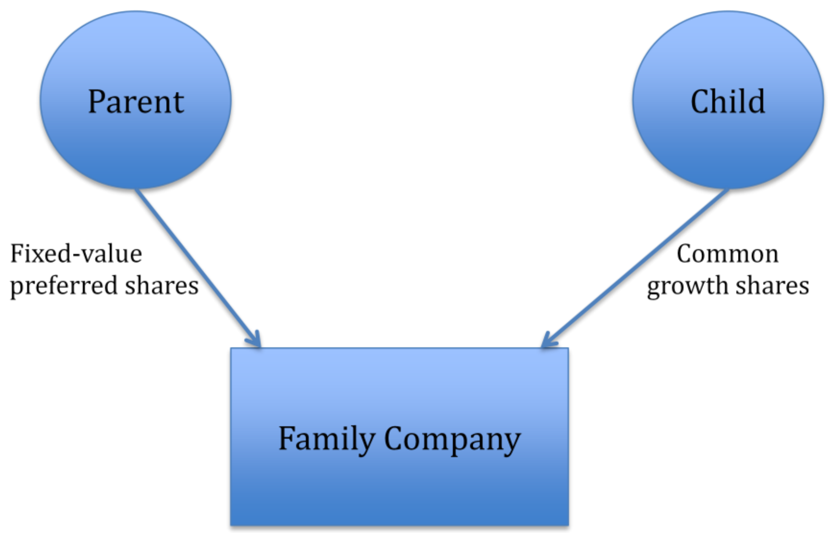
David Louis, one of the most prolific Canadian authors on the subject of estate freezes, defines an estate freeze as follows:

> An estate freeze refers to the transfer of the future growth in value of a business, investments or other assets into the hands of subsequent generations (the "Children"). The current owners (the "Parents") are effectively divested of this future growth. An estate freeze typically limits the value of the Parents' estate to the value at the date the freeze is implemented (the freezor typically retains the current value of the asset, although often in a different form). Accordingly, capital gains and other tax exposure on the future growth that would otherwise arise when the assets pass from Parents to Children are avoided. [1]

This definition emphasizes the use of a share value freeze as an estate planning tool. One of the most common motivators for an estate freeze is the desire to pass future value growth of capital assets onto the next generation of a family, thereby minimizing the income tax which will arise on the deemed fair market value disposition which will occur on the death of the parents.[2] In a family business, a process that permits the tax-effective transfer of growth to the next generation should also have the (arguably more important) effect of creating a greater incentive for the new generation to remain loyal to and promote the success of the family corporation.

As we will see, a basic estate freeze could be implemented by having the parent exchange his or her common growth shares of the family corporation for preferred shares having a fixed (or "frozen") value equal to the fair market value of the common shares exchanged, and then having the child subscribe for new common shares for a nominal value. If properly structured, the parent will not have made a taxable disposition and no taxable benefit will have been conferred on the child, since the full present value of the corporation is represented in the preferred shares issued to the parent in the exchange.

The following chart depicts the ownership structure at the conclusion of a basic estate freeze in a family corporation:



In addition to estate planning motivations, a share value freeze can help achieve other business, succession and tax-planning goals. One commonly encountered motivator (in family and non-family businesses alike) is the wish to ease entry of key employees into partial ownership of a business, to promote loyalty and dedication, and possible succession to more full ownership in future. This need often arises in mature corporations, with accrued value. The question arises: How can the corporation issue participating shares to a new entrant in a manner that does not confer a benefit as a result of a transfer of existing value, which would have inappropriate commercial and tax consequences?

In some cases, the owner may wish to recognize the value of an employee, or an employee's past contributions, through advantageous entry terms; but this can create particular challenges, including exposure of the employee to reassessment under the employee benefit provisions of the *Income Tax Act*.[3] While some of these challenges may be mitigated using the employee stock option provisions in the *Income Tax Act*[4], the use of a share value freeze can give flexibility in extending ownership to a key employee -- without a substantial financial burden being imposed on the employee -- with deferral of tax on a disposition for the original owner.

A share value freeze may also be needed for the shareholders of an established corporation to convert, on a tax-efficient basis, to an ownership structure which will permit income splitting, whether in respect to dividends, future capital gains on sale of the shares of the corporation, or both. In some cases, this type of reorganization will be needed to transfer ownership of future growth with a view to accessing other family members' $750,000 lifetime capital gains exemption eligibility[5]; the goal in such a case is to shelter future gains on the sale of qualified small business corporation shares -- a goal that can be achieved, without giving up control of the corporation, though the issuance of non-voting growth shares to the beneficiary of the freeze, or by holding the new growth shares in a family trust – more on that later.

An estate freeze may be **full** or **partial**. A full estate freeze results in the present owners fully divesting themselves of any participating (growth) shares going forward, whereas a partial freeze will see the present owners re-subscribing for a portion of the new growth shares, with the remainder being taken by one or more new owners.

2. When a client should (and should not) implement an estate freeze

The time when a share value freeze should be undertaken will depend on the type of freeze and motivation for implementing it.

A classically-motivated full estate freeze made directly to one or more children of the freezors, without a family trust – one intended purely to shift all future growth to the next generation of a family -- should only be undertaken after the most careful consideration. Such a freeze should only be implemented when the value of the preferred shares issued to the parents represents enough value to fund comfortably the parents' eventual retirement.

The questions relevant to this kind of freeze are therefore: Is there enough accrued value in the company's shares to justify a freeze? And - How much value is enough for the parents' retirement? The latter question, in particular, is a difficult matter to gauge and may require input from a financial planning professional. Most company owners do not wish to contemplate the possibility of having to go back to their children years from now to ask for support because their freeze shares have been used up and they cannot support their lifestyle anymore. The potential dissatisfaction of the parents in this scenario will be much worse where a freeze beneficiary has sold the corporation at a large gain in the meantime.

While it is possible to "thaw" or "re-freeze" a corporation to re-introduce the parents into ownership of growth shares, where value has grown into growth shares issued in a previous freeze, that value is difficult to transfer back to the parents without adverse income tax consequences[6]. Moreover, this type of reorganization will not be possible without cooperation from the child-beneficiary of the previous freeze.

Where there is any doubt about these matters, a partial freeze only should be undertaken, or even better, a freeze in favour of a family trust, which includes the parents as beneficiaries is indicated. This approach is discussed below.

Determining whether a family is ready for the change in family dynamics which an estate freeze may bring requires thoughtful discussion and analysis, with sensitivity from professional advisers to both financial and non-financial factors which may come into play. Among the considerations that should be addressed are:

- the parents' life expectancy;
- lifestyle and income needs;
- the impact of expected inflation;
- the ability of the children to responsibly manage and preserve directly-controlled wealth (bearing in mind both factors which are within control and those which are not – such as potential exposure to family law claims);
- whether the parents have identified which of their children are suited for taking over ownership and eventually control of the family business;
- how even-handedness in estate planning can be achieved if only one of several children is identified as the beneficiary of the freeze; and
- the ability of the company to fund orderly redemptions to finance the parents' retirement when the time comes.

Louis, Prasad and Goldberg comment:

> The psychological effects of estate freezing (as well as income splitting) should be considered carefully, as the outcome may place substantial assets in the hands of children (although an element of control may be available through the use of family trusts and so on). The personal effects from the point of view of both the parents and the children should be considered carefully.[7]

Even the most tax-advantageous plan may founder on the shoals of family dynamics and the exigencies of wealth preservation.

3. How to implement an estate freeze

David Louis identifies three main types of estate freezes:

> - **freeze of assets**, wherein previously unincorporated assets are transferred to a corporation in return for freeze shares

> (redeemable and retractable based on the value of the pre-existing assets);
>
> - **holding company freezes**, whereby the corporation’s shares are transferred to a holding company in return for such freeze shares … ; and
>
> - **internal freezes**, whereby the shares of an existing corporation are reorganized into a freeze configuration (usually pursuant to section 86 of the *Income Tax Act*, but there are other methods as well ….).

While estate freezes may be implemented using a partnership structure, the technical aspects of such a freeze are beyond the scope of this paper. By far, most estate freezes are implemented with corporations.

A. Asset Freezes

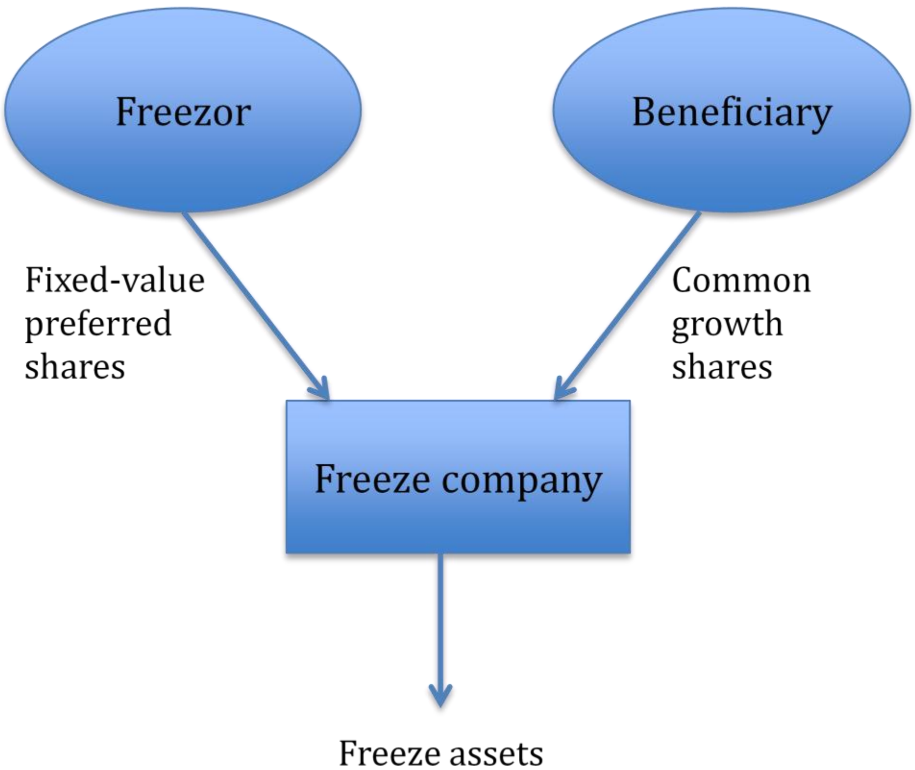
This type of freeze involves capital assets, including business assets held as a proprietorship, real estate investments, portfolio stock, bond or mutual fund investments, and similar assets. It is typically motivated by a desire to transfer some or all of the future taxable growth in the value of the assets to the next generation of a family or to permit income splitting with new owners.

The steps to implement a freeze of assets with appreciated tax value are as follows:

1. A corporation is set up and common shares issued to the person or persons in favour of whom the freeze is being made (the “beneficiary”). As noted, in an estate-planning motivated freeze, this will typically be one or more children of the parent (the “freezor”).
2. The freezor makes a transfer of the subject assets to the corporation pursuant to subsection 85(1) of the Act and receives in consideration fixed-value preferred shares and possibly other consideration, such as a non-interest bearing promissory note (commonly called “non-share consideration” or “boot”)

which will correspond to the tax "cost amount" of the assets transferred. The "cost amount" is generally the undepreciated capital cost of depreciable property or the adjusted cost base of non-depreciable capital property[8], value which can be extracted by the freezor, usually without immediate tax consequences.

The following chart shows the ownership structure following implementation of a full asset freeze:



Asset freezes are implemented by transferring the assets to a corporation pursuant to subsection 85(1) of the Act. While the requirements for a valid section 85 rollover are not the focus of this paper, several key requirements are worth noting.

The transfer must be made for consideration of a value equal to the fair market value of the assets, as required by the Act[9], for consideration that must include shares[10], and at a jointly-elected tax amount which must generally range between the fair market value of the assets and their cost amount. An election form (T2057) must be filed with the Canada Revenue Agency ("CRA"). For purposes of a freeze, the elected amount will usually be the minimum amount available under the rules, as the desire will be to defer any present recognition of taxable gains. The possibility of crystallizing exempt capital gains on a transfer of qualifying property should be addressed -- for example, where the property being frozen is "qualified farm property"[11].

Where the desire is for only a partial freeze of the assets' value, the corporation will be organized such that the freezor, in addition to the beneficiary, will have received a portion of the common shares in the course of implementation. Future growth in the value of the freeze corporation's shares will then accrue to the benefit of the holders of the common shares in proportion to their holdings.

Control of the freeze corporation should be addressed. The freezor will usually wish to maintain control of the assets being transferred to the freeze corporation for the foreseeable future. This is can be achieved by making the freeze shares voting preferred shares, and issuing them in a sufficient number such that it will allow the freezor to outvote the beneficiary, at least until the preferred shares have been substantially paid out and redeemed.

Issues of control can usually be most effectively addressed through use of a discretionary family trust as the beneficiary of the freeze – a subject we will return to presently. In such a structure, the freezor may decide to maintain voting control through what have been termed "**thin voting shares**" – a separate, additional class of retractable shares which carry votes but have a nominal fixed value and no dividend entitlement.

B. Holding Corporation Freezes

This type of freeze occurs when a shareholder of a corporation (often an active business corporation, referred to as "**Opco**") transfers his or her shares to another corporation (customarily called a holding corporation, or "**Holdco**").

There are good and valid motives for setting up a holding corporation structure, aside from estate planning. The most important of these is the desire to create a corporate structure which facilitates tax-efficient creditor-protection of accumulating corporate profits (or "retained earnings") and any unrealized capital gains which are accruing in capital assets used in the business. Where the corporation does not have any present creditor issues, these assets may be protected against future reverses in business by utilizing a holding corporation structure.

Retained earnings can be protected in a holding corporation structure by having the corporation declare and pay an inter-corporate dividend, or execute an inter-corporate redemption, with proceeds equal to the retained earnings, between Opco and Holdco. Assuming the two corporations meet the test of "connected corporations"[12] in the Act (which will always be the case when Opco is a wholly-owned subsidiary of Holdco), no tax liability will arise as a result of the dividend.[13] Where extracted retained earnings are required by the Opco to finance working capital or other assets used in the business, the proceeds of the dividend may be lent back to Opco by Holdco and secured, for example, by the granting of a general security agreement. In this manner, share equity in the form of retained earnings is converted into a secured inter-corporate loan.

Of course, the retained earnings of a corporation held by individuals can be creditor-protected without a holding corporation structure, by paying dividends to the individual shareholders, but only at a cost of incurring personal dividend tax. The top combined marginal rate charged in Alberta on such dividends in 2012 ranges from 19.29% for eligible dividends to 27.71% for ineligible dividends.[14]

Unrealized capital gains accruing in assets used in the business can also be creditor-protected in a holding corporation structure by relocating these assets from the Opco to the Holdco or another corporation owned by the Holdco, which can usually be achieved without triggering immediate tax liability. An important exception which must be noted arises where an unrelated person (as specifically defined in the Act for this purpose) acquires a greater interest in the course of the reorganization, which will bring Subsection 55(2) of the Act into play. This provision of the Act restricts the movement of accrued capital gains between corporations on a tax-deferred basis using tax-free inter-corporate dividends[15]. In a holding corporation freeze in favour of children, the related party exception to subsection 55(2)[16] will apply to prevent its application.

In a holding corporation freeze, Holdco will have been organized such that the holder or holders of the common shares are the intended beneficiaries of the freeze. Where the shares of Opco have appreciated tax value, the transfer of the Opco shares will generally take place as a rollover at tax cost under subsection 85(1) of the Act, although Section 85.1 could also be used to permit a tax-deferred transition to this structure. The freeze occurs when the share consideration issued in the rollover is in the form of fixed value preferred shares issued to the freezor.

The typical steps for a holding corporation freeze are:

1. Holdco is set up and common shares are issued to the person or persons who are to be the freeze beneficiaries. As with an asset freeze, in an estate-planning motivated freeze, this will typically be one or more children of the freezor.
2. The freezor makes a transfer of the Opco shares to Holdco pursuant to subsection 85(1) of the Act and receives as consideration fixed-value preferred

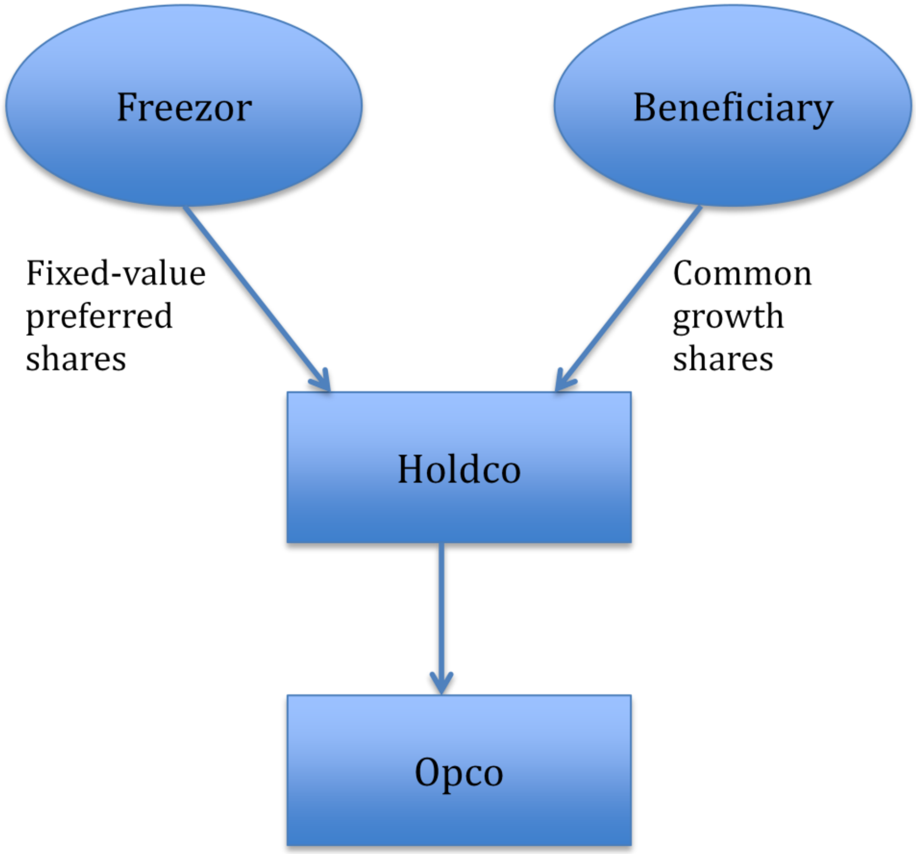
shares of Holdco having a redemption value equal to the fair market value of the Opco shares, with a tax paid-up capital equal to the tax paid up capital of the Opco shares[17] and possibly other consideration, such as a non-interest bearing promissory note.

The tax paid up capital of the preferred shares plus the fair market value of non-share consideration will usually correspond to the adjusted cost base of the Opco shares. Beware, however, of section 84.1 of the Act, which Louis calls “one of the most dangerous traps in the Act”[18]. In this provision, a different, more restricted definition of adjusted cost base applies[19], one which has been called “arm’s length hard cost”[20]. Generally, this definition excludes cost resulting from transactions between persons not at arm’s length with the transferor and cost created where a party has utilized capital gain exemption to shelter his or her gain. The results can be draconian:

> For example, if non-share consideration is received on a transfer of shares and the non-share consideration exceeds the greater of the shares’ PUC [paid up capital] and the hard cost, section 84.1 deems a dividend to have been received by the transferor.[21]

Unlike an asset freeze involving property like “qualified farm property” (as mentioned above), a capital gains exemption crystallization of “qualified small business corporation” shares[22] must be approached with caution. Cost base of Opco shares created by application of the capital gains exemption may not be extracted in this manner as non-share consideration by way of a promissory note or paid-up capital without running afoul of section 84.1.

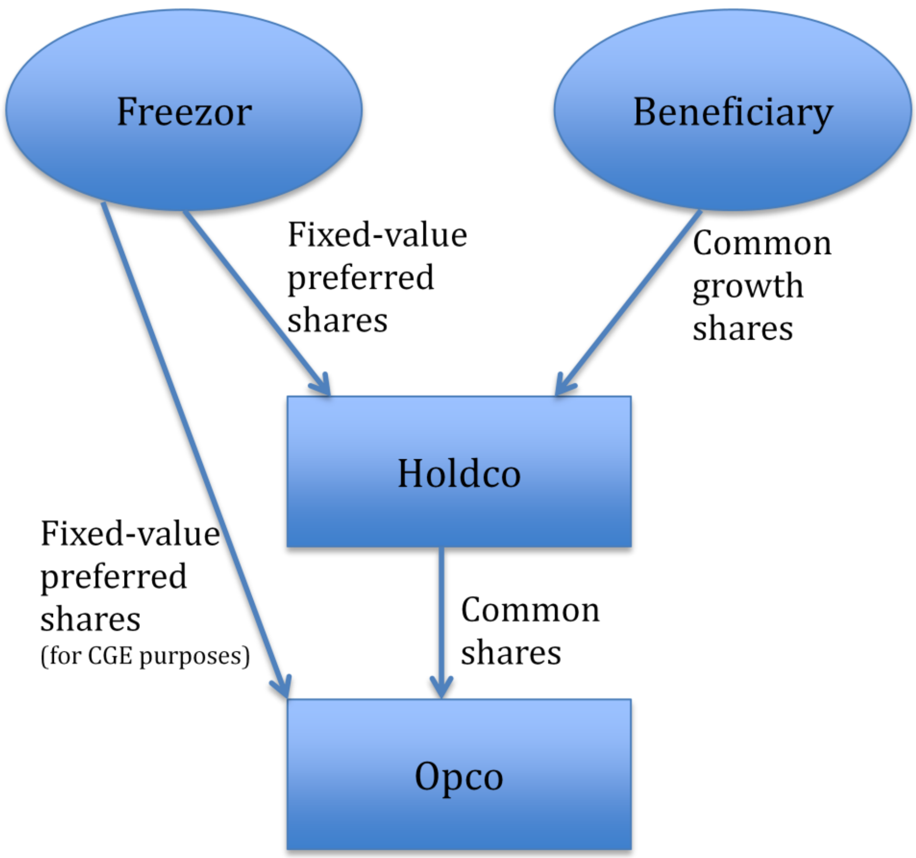
The following chart shows the ownership structure following implementation of a full holding corporation freeze:



One noticeable shortcoming of the structure depicted above is that the shares of Opco will not meet the definition of shares of a "qualifying small business corporation" (QSBC) which are in themselves eligible for capital gains exemption under Section 110.6 of the Act. This is because the shares are no longer held by an individual[23]. The shares of Holdco may qualify at the inception of the structure, but if Holdco is used as a safe repository for accumulating profits of Opco, these shares may well go "offside" before long as they may cease to meet the "determination time" test requiring 90% of the assets of the corporation to be used in an active business carried on in Canada[24]. There will be too much value represented by cash or non-business investments in Holdco.

A simple method to preserve the freezor's ability to use his or her capital gains exemption on a future sale of Opco would for Opco to declare a stock dividend in the form of preferred shares having a redemption value equal to the amount of the freezor's remaining lifetime capital gains exemption eligibility (up to $750,000) prior to the freeze. The stock dividend shares should qualify as QSBC shares immediately (without having to satisfy the two-year holding period test[25]) as long as the common shares the dividend was declared upon so qualified at the time the dividend was paid.

The following chart shows the ownership structure following implementation of the holding corporation freeze, with a stock dividend to preserve the freezor's ability to access capital gains exemption on a future sale of the shares of Opco:



A secondary freeze could be undertaken to freeze the common shareholding of Holdco in Opco. This would allow Beneficiary to subscribe for common shares of Opco directly, with a different class of post-freeze common shares being issued to Holdco. Future retained earnings could then be removed up to Holdco on an ongoing basis, while permitting Beneficiary to hold shares directly in Opco which could qualify for the capital gains exemption.

Lawyers should consider recommending this strategy even where the frozen family Opco is expected to pass from parent to child, and not be sold by the parent. It would permit the parent's available capital gains exemption to be used to step up the adjusted cost base of stock dividend shares, which can pass to the child under the parent's will. Should there be a sale after the company is taken over by the second generation of the family, this will save tax in the future.

Another approach to this issue would be to crystallize capital gains exemption on the transfer to the Holdco by electing at an amount higher than the adjusted cost base of the shares and triggering a capital gain on the transfer. This has the additional advantage of locking the tax saving of the capital gains exemption into the adjusted cost base of both the Opco shares held by Holdco and the Holdco shares held by the freezor. This would protect against legislative changes removing or limiting capital gains exemption in future, as well as future changes to Opco which might preclude a capital gains exemption from being claimed in the future, such as Opco's ceasing to satisfy the various tests. However, this can only be done to the extent that there is sufficient fair market value in the common shares at the time of the freeze, since Section 85 of the Act precludes an election above fair market value.

The considerations regarding full versus partial freezing and control of Holdco apply to a Holding Corporation freeze in the same manner as discussed above in relation to an Asset Freeze.

C. Internal Freezes

Unlike an Asset Freeze and a Holding Corporation freeze, an internal freeze may be carried out without introducing a new corporation to the ownership structure. As Louis has noted[26], this means the cost of implementation is somewhat lower. But this saving comes at the cost of the tax-efficient creditor protection available in a holding corporation freeze discussed above.

In this type of reorganization, the freezor will exchange shares in a corporation of a class which carries with it the right to participate in future growth in value of the corporation, for shares of another class which has a fixed or “frozen” value.

An internal freeze may be achieved on a tax-deferred basis under any of the following provisions of the Act:

- **Section 86 –** This provision allows an automatic rollover (i.e. no election is required to be filed as with a Section 85 rollover) where:
  - A taxpayer has disposed of shares in exchange for property received from the corporation which includes other shares issued by the corporation;
  - The exchanged shares were capital property to the taxpayer;
  - The exchanged shares were all the shares of a particular class that were owned by the taxpayer; and
  - The transfer occurred in the course of a reorganization of capital of the corporation.

Note that like Section 85, this provision allows the corporation to give non-share consideration back to the shareholder as part of the exchange, as long as the total consideration package includes other shares of the corporation.

What constitutes a “reorganization of capital” is not defined in the Act. The CRA has commented that[27]:

> The general position of the CRA is that, in the context of subsection 86(1) of the ITA, a reorganization of the capital of a corporation should normally require amendments to the articles of a corporation.

Some might interpret this position as meaning that the disposition must occur *by means of* the filing of Articles of Amendment -- for example, by Articles of Amendment filed with Alberta Corporate Registry pursuant to Subsection 177(1) of the Alberta *Business Corporations Act*, RSA 2000, c B-9 (the "ABCA"), after a special resolution adopted under Paragraph 173(1)(f), which permits amendment of the Articles of a corporation to:

> (f) change the shares of any class or series, whether issued or unissued, into a different number of shares of the same class or series or into the same or a different number of shares of other different classes or series,….

However, in practice, a share exchange which occurs immediately after (and is facilitated by) an amendment to the Articles of a corporation (such as an amendment under Paragraphs 173(1)(d) or (e) of the ABCA) has long been accepted as occurring "in the course of" a reorganization of share capital[28]. This approach also has the benefit of permitting an exchange agreement to be signed which includes a price-adjustment clause.

- **Section 51 –** This provision goes even further than Section 86 in that it deems no disposition to have occurred where:
    - A taxpayer has exchanged shares for other shares of a corporation;
    - The exchanged shares were capital property to the taxpayer; and
    - No consideration other than the new shares issued by the corporation has been received by the taxpayer.

Here, unlike Section 86, there is no requirement that the shares exchanged be all the shares of a particular class owned by the taxpayer. Nor is it required that the exchange occur in the course of a reorganization of the share capital of the corporation. But like Section 86, there is no requirement for the filing of an election in order to defer tax consequences from the transfer.

It is possible to implement a freeze under Section 51 because the shares being received in the exchange can be fixed value preferred shares. It is generally the simplest method of implementing an internal freeze.

- **Section 85** –The discussion of considerations to be weighed in a Holding Corporation Freeze which appears above applies here, with the distinction that no new corporation has been introduced to the structure. In the rollover agreement, the freezor is the transferor, the corporation itself is the transferee, with the subject matter of the rollover being its own shares. A joint election in CRA Form 2057 must be filed to ensure that any capital gain that might otherwise arise on the disposition of the growth shares is deferred.

There are a couple of other methods of implementing an internal freeze which should be noted:

- **Stock dividend –** Assuming, for the sake of simplicity, that the corporation has only one class of common shares issued and outstanding in the hands of the freezor, a stock dividend estate freeze could be implemented as follows:
    - The corporation will issue a stock dividend to the freezor.
    - The dividend will be in the form of fixed value preferred shares having an aggregate redemption value equal to the fair market value of the common shares.
    - Pursuant to subsection 44(2) of the ABCA, the directors will resolve to add to the stated capital account maintained for the stock dividend preferred shares a nominal amount only.
    - As a result of the definition of "amount" in Subsection 248(1) and Section 82 of the Act, this will result in a taxable dividend being received for tax purposes by the common shareholder only in the amount of the stated capital addition – a nominal amount.

- Because the preferred shares are entitled to the first distribution on the wind-up of the corporation to the extent of their redemption value, the stock dividend will have the effect of shifting the share equity value away from the common shares of the corporation, and over to the stock dividend preferred shares.
- The shares issued in a stock dividend of this kind are said to be "high / low" shares (meaning high fair market value, low stated capital / adjusted cost base).
- The directors will authorize the issuance of new common shares to the beneficiary of the freeze in a proportion which will correspond to the planned division of future growth in the estate freeze plan.

- **Amalgamation –** This is an internal freeze only in the sense that at the end of the process, there could be only one corporation. However, by definition, a freeze via an amalgamation must start with more than one corporation. It can be achieved by way of a long-form amalgamation under Subsection 182(1) of the ABCA. Assuming, again for the sake of simplicity, that the corporation to be frozen ("Freezeco") has only one common shareholder (the "freezor"), an amalgamation estate freeze of Freezeco could be implemented as follows:
    - A new corporation ("Newco") is set up with common shares being issued for nominal value to the beneficiary of the freeze;
    - An amalgamation agreement is entered into between Newco and Freezeco, and approved by special resolutions of both corporations, under the terms of which the freezor will receive fixed value preferred shares of the amalgamated corporation ("Amalco") having a redemption value equal to the fair market value of the common shares formerly held

in Freezeco, in exchange for giving up those common shares in the course of the amalgamation;

- The beneficiary will receive the common shares of Amalco to the extent that Amalco is intended to be frozen in his or her favour;
- Articles of Amalgamation are filed and shares issued accordingly.

Section 87 of the Act will operate such that the freezor will receive rollover treatment on the disposition of his shares in Freezeco and the other tax attributes of the Freezeco shares will flow over to his new shares in the Amalco.

4. Family Trusts

A discretionary family trust is a particularly useful tool in an estate freeze of a family corporation, and facilitates succession planning. The key feature of a family trust is the power of the trustees (usually the parents, who control the family company) to appoint the capital and income of the trust to one or more beneficiaries specified by name or class. This will include an express and unfettered discretion to exclude other beneficiaries. Where the trust is constituted for the purpose of holding shares of a family corporation, it will allow the trustees to decide who among their children will receive the shares, once the children have grown up and demonstrated their interest and ability with regard to the family business. It can also be used to distribute the proceeds of the shares, should the parent decide that the shares will be sold or the corporation wound up.

Shares which are issued to a family trust after a properly implemented estate freeze will have nominal value. Should the value of the corporation's shares grow in the succeeding years, the capital gain which has accrued need not be realized for income tax purposes at the time the shares are distributed to the appointed beneficiary, provided the beneficiary meets the requirements for a tax-deferred roll-out in Subsection 107(2) of the Act. One of the most important of these requirements is that the beneficiary be a Canadian resident.

A discretionary family trust allows parents some ability to protect a family's growing wealth, to the extent that wealth resides in the growth shares of the family corporation. It may set that wealth aside for the children, with the ability to exclude any child who encounters future creditor problems, marital or family law claims or similar issues.

A family trust is an excellent way to split income generated from dividends paid by the family corporation. Subject to the application of the corporate attribution rule (discussed below), the trust can be used to transfer income to a spouse who is liable for tax at a lower marginal rate. Most usefully, once children reach age 18 (and are therefore no longer liable for the "kiddie tax"[29]), dividend income paid from the family corporation may be allocated to one or more of them, and will be taxable in their hands at their rates. This is tax efficient, for example, when children are involved in post-secondary education and require continuing parental support.

Another useful feature of a properly instituted family trust structure, whether instituted by way of an estate freeze or at the inception of a family corporation, is the potential to engage multiple family members' capital gains exemption eligibility on the sale of a family corporation which is held through a trust. A properly-drafted family trust will allow the trustees to allocate capital gains to multiple beneficiaries, who can then each use their respective capital gains exemption to shelter their part of the gain, with each beneficiary using up to the lifetime eligibility limit of $750,000.

In deciding whether to set up a family trust, and in the structuring of a trust, the family needs to be mindful of the "21 year rule"[30]. This tax rule provides that certain trusts, including a discretionary family trust of the kind we are discussing, are deemed to have disposed of all their capital property (like the shares of the family corporation) on the 21st anniversary of the trust being constituted, and every 21 years thereafter. The purpose of this rule is to prevent a trust being used to indefinitely postpone the recognition of capital gains, which are otherwise deemed to be realized for tax purposes on the death of an individual owner.

The following are features of the constitution of a family trust which should be considered:

- To minimize the risk of application of tax attribution rules which could frustrate the planning intent of the family trust, it should be settled by someone other than the parents, such as a grandparent or friend of the family. The settlor must not be included as a beneficiary of the Trust to minimize the risk of attribution under Subsection 75(2) of the Act.
- The Trust may be settled with a valuable token such as a gold coin, a silver bar or a $50 bill, gifted by the settlor, and acknowledged in the deed or a separate receipt. The settlor must not be reimbursed for this, which could create risk of attribution to the parents. The token should be retained with the Trust Deed as evidence that the settling gift was actually delivered to the trustees.
- The list of beneficiaries is important. It will usually include the children, but should also include grandchildren. This will allow benefits to flow down should a child die prematurely.
- It is a wise practice to include two additional classes of beneficiary:
    - A Canadian resident corporation, the shares of which are wholly-owned by a beneficiary. This will facilitate a roll-out of assets of the trust for the benefit of a beneficiary who has ceased to be a resident of Canada; and
    - A trust constituted for the benefit of a beneficiary. This would allow a Canadian resident trust to receive a tax-deferred roll-out for the benefit of a

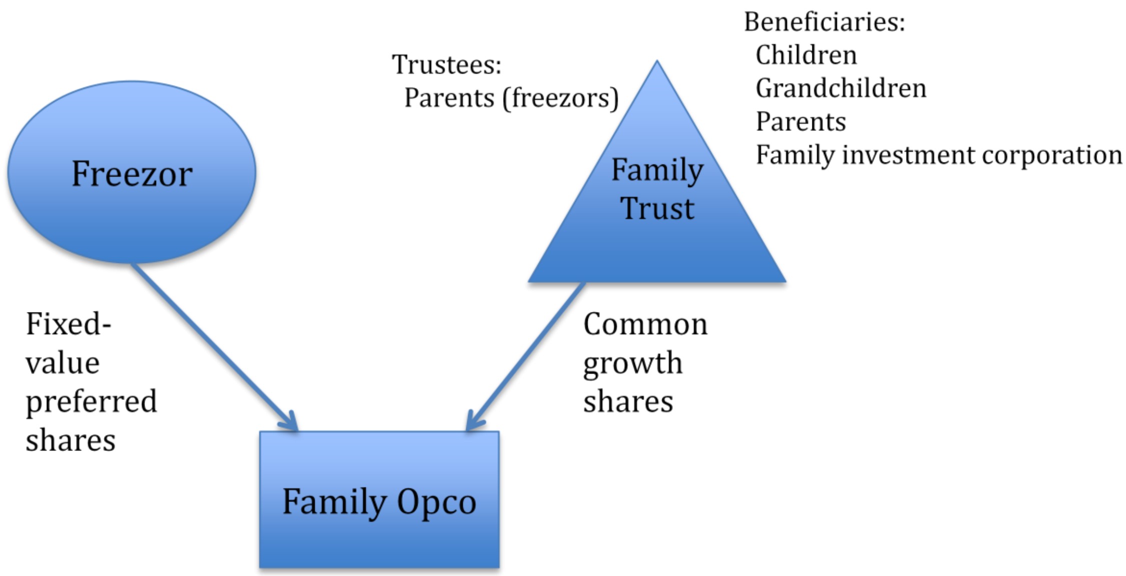
non-resident beneficiary, and facilitate planning around subsection 104(18) of the Act, which allows transfers to a vested trust set up for the benefit of a minor.

- Including a family investment corporation as a beneficiary can allow for the tax-efficient removal of retained earnings from a family operating corporation, the shares of which are held by the family trust. This can be helpful in creditor-proofing the family corporation and preventing the corporation from going “offside” of the 90% business asset test for QSBC treatment. Dividends paid to the trust and allocated to the family investment corporation will often be eligible for the section 112(1) deduction, so as to have the same treatment as dividend paid to a “connected” holding corporation.
- Including a specific “power of appointment” in favour of the parents allows the parents to direct benefits from the trust as between the beneficiaries, even if the parents have ceased to be trustees – for example, on their deaths. A good power of appointment clause will permit the parents to include this type of direction of a Will or other written deed.
- It is prudent to specify a default distribution scheme, so that if the parents have died or lost capacity prior to exercising their power of appointment, the property will be distributed in a particular fashion – for example, equal division between the children of the parents then alive. In effect, the discretionary family trust will have ceased to be discretionary, and succeeding trustees will know how the parents wished to distribute benefits from the trust, and be bound by those wishes.
- It is usually prudent to include the parents themselves as potential beneficiaries, which allows a “bailout” option, in case the parents decide to end the trust early, or need to control more value than is represented by their freeze shares, for any

reason. Care will need to be taken with other structuring steps to ensure that this inclusion does not expose the structure to application of attribution rules, discussed below.

- To avoid an accidental application of the 21-year rule, some family trusts will specify that they will automatically be wound up and distributed on the day before the 21st anniversary of the trust. However, such a provision limits flexibility in planning in the future. It is sufficient to include a provision that allows the trustee to declare the division date and wind-up the trust at any time, with broad capital encroachment powers, which permit the distribution of appreciated property from the trust, while allowing the trust to continue. For example, this would permit trustees holding appreciated shares of a family corporation to perform a share value freeze prior to the 21st anniversary, moving the gain in the shares into freeze preferred shares, and distribute these shares out of trust, before the deemed disposition takes place. When the 21st anniversary occurs, there would then be no "pregnant gains" left in the trust.
- The selection of trustees and beneficiaries can unwittingly trigger association of corporations[31], leading to limitation of the ability to claim small business deduction in the affected corporations. Where shares of other corporations are owned by these parties, or might be in future, this issue should be addressed to avoid unintended consequences.

A trust structure planned for maximization of capital gains exemption potential might look like this:



5. Technical Issues

A. Valuation and Benefit Conferral

The overriding technical concern in implementing an estate freeze is to ensure that value of consideration given to the freezor is commensurate with the value of the property he or she is giving up in the freeze.

In an exchange of shares or other property for fixed value preferred shares, the fair market value of the preferred shares must be equal to the fair market value of the shares or other property exchanged. Failure to observe this requirement can expose either the freezor or the beneficiary to assessment under one or more of the following provisions of the Act:

- Subsection 15(1) – shareholder benefits;
- Subsection 56(2) – indirect payments;
- Subsection 246(1) – benefits conferred;

- Paragraph 85(1)(e.2) – where the freeze has been implemented by way of a transfer of capital property to a corporation under subsection 85(1) and a benefit has been conferred on a related person;
- Subsection 86(2) – where the freeze has been implemented through a corporate reorganization under subsection 86(1) and a benefit has been conferred on a related person;
- Subsection 51(2) -- where the freeze has been implemented by way of a share exchange of shares of a single corporation under subsection 51(1) and a benefit has been conferred on a related person;
- Subsection 87(4) – where the freeze has implemented in the course of an amalgamation and a benefit has been conferred on a related person;
- Subsection 15(1.1) -- where the freeze has been implemented through issuance of a stock dividend and a benefit has been conferred on a related person

It should be noted as well that Section 69 of the Act gives CRA the ability to re-value for tax purposes property which has passed between non-arm’s length persons, where consideration given to the transferor is found to be inadequate, although this re-valuation is subject to appeal. Where the transfer has been made, for example, under Section 85 at an elected amount set to defer tax, the re-cast value may trigger a capital gain inclusion in the hands of the transferor, or a benefit conferral under Subsection 15(1).

There are two dimensions involved in ensuring that the fair market value of freeze shares (less the value of non-share consideration) is equal in value to the property being given up in a freeze. First, the redemption or face value of the freeze shares must be selected with consideration given to the fair market value of the property given up. Arriving at an appropriate value for this property transfer will usually require accounting and valuation support. Where one is dealing with the freeze of a corporation which is operating a business, a business valuation report from an appropriately qualified valuator may be necessary to avoid problems in the future. Where real estate is a significant component of the freeze corporation's underlying assets, an appraisal report from an appropriately qualified appraiser is recommended.

The second dimension to be considered is the rights attached to the freeze shares. The CRA has made several pronouncements on appropriate share rights for freeze shares, and one that is often quoted is the following[32]:

> The Department is concerned that the value (redemption amount) of the preferred shares issued plus other consideration given is equal to the fair market value of the property transferred.
>
> Our position is that the preferred shares must be redeemable at the option of the holder. The preferred shares should be entitled to a dividend. In any case, the dividend must not exceed a reasonable amount. The shares may or may not have voting rights; however, such shares should at least have voting rights on any matter involving a change to the rights, conditions, or limitations attaching to them, sufficient to protect those rights, etc.
>
> It is essential that the value is maintained and, accordingly, there are other rights which must be attached to the preferred shares, such as a preference on any distribution of the assets of the corporation on any liquidation, dissolution, or winding-up, and no restriction on the transferability of the shares (other than restrictions required by corporate law to qualify the company as a private company). In addition, the corporation must undertake that no dividends will be paid on the other classes of shares which would result in the corporation having insufficient net assets to redeem its preference shares at their redemption amount.

Note that the dividend requirement has been held to be satisfied by specifying that non-cumulative dividends will be payable in the discretion of the Board[33]. The rate of the dividend should be specified in the freeze documentation, rather than by way of a formula, to avoid the possibility of triggering Part IV.1 or Part VI.1 when they are later redeemed.

Prior to implementing a freeze, it is important to ensure that the rights attached to the freeze shares conform to these requirements. The lawyer should review the Articles of the corporation to ensure compliance.

It is generally prudent to include a price adjustment clause both in the Articles of the freeze corporation and the transfer or exchange agreement. Inclusion of a price adjustment cause, however, does not relieve the parties of the requirement to make a bona fide effort to determine the proper value at which the freeze should take place. If such bona fide efforts have been made, then CRA policy is generally to give effect to a price adjustment clause to permit the parties to adjust values so as to eliminate benefit conferral or other adverse tax consequences, which could otherwise result in double taxation.

Interpretation Bulletin IT-169 is reproduced here and sets out the CRA's position relative to price adjustment clauses:

IT-169-- Price Adjustment Clauses

Date: August 6, 1974
Reference: *Section 3* (also section 69 and subsection 15(1))
Income tax --- Special rules—Relationships

1. Where property is transferred in a non-arm's length transaction, the parties sometimes include a price adjustment clause in the covering agreement. This bulletin deals with those agreements which state that if the Department determines that the fair market value of the property is greater or less than the price otherwise determined in the agreement, that price will be adjusted to take into account the excess or the shortfall. The Department is only concerned in the valuation for purposes of administering the Act and determining the tax consequences. It is neither a valuator nor an arbitrator for the parties. If the parties have agreed that, if the Department's value is different from theirs, they will use the Department's value in their transaction, that is their choice and the Department will recognize that agreement in computing the income of all parties, provided that all of the following conditions are met;

> (a) The agreement reflects a *bona fide* intention of the parties to transfer the property at fair market value and arrives at that value for the purposes of the agreement by a fair and reasonable method.
>
> (b) Each of the parties to the agreement notifies the Department by a letter attached to his return for the year in which the property was transferred(i) that he is prepared to have the price in the agreement reviewed by the Department pursuant to the price adjustment clause,(ii) that he will take the necessary steps to settle any resulting excess or shortfall in the price, and(iii) that a copy of the agreement will be filed with the Department if and when demanded.

(c) The excess or shortfall in price is actually refunded or paid, or a legal liability therefor is adjusted.

2. Whether the method used by the parties to determine fair market value is fair and reasonable in the Department's view will depend on the circumstances in each case.

3. In recognizing the price adjustment clause, appropriate adjustments in computing the income of all parties to the agreement will be made in their taxation years in which the property was transferred. If the purchaser has filed returns and claimed capital cost allowances, deductions from income based on cumulative eligible capital, or exploration and development expenses in respect of the property for taxation years subsequent to that in which it was transferred, any necessary adjustments will be made in those subsequent years. Likewise, any reserves claimed by the vendor to defer the reporting of income will be adjusted.

4. Amended Forms T2022 on the sale of accounts receivable or amended agreements on the price paid for inventory may be required.

5. If all the conditions mentioned in paragraph 1 are met, the Department will not apply subsection 15(1) to tax a benefit to shareholders.

6. Where taxpayers have included price adjustment clauses in agreements that relate to transactions reported in tax returns already filed, they should notify the District Office immediately if they wish to have the clause considered in the light of the comments in this bulletin.

The following is an example of a price adjustment clause which could be included in the Articles of Incorporation:

> The redemption amount of each Preferred share shall be set by the Directors at the time of issuance. In the case where shares are issued in exchange for other property, the redemption amount shall be determined with reference to the amount of consideration received therefor as determined by the Directors of the Corporation, and adjusted by the Directors at any time or times so as to ensure that the redemption amount of any such Preferred shares issued as partial or total consideration for the purchase by the Corporation of any assets or the conversion or exchange of any shares (the “Purchased Assets”) shall equal the difference between the fair market value of the Purchased Assets as at the date of purchase, conversion or exchange, and the aggregate value of any non-share consideration issued by the Corporation as partial or total consideration for the Purchased Assets. For greater certainty, such fair market value shall be determined by the Directors upon such expert advice as they deem necessary. Should, however, any competent taxing authority at any time issue or propose to issue any assessment or assessments that impose or would impose any liability for tax on the basis that the fair market value of the Purchased Assets is other than the amount approved by the Directors, and if a competent Court or tribunal

> agrees with such revaluation, and all appeal rights have been exhausted, or all times for appeal have expired without appeals having been taken, or should the Directors otherwise determine that the fair market value of the Purchased Assets is other than the amount previously approved by the Directors, then the redemption amount of the relevant Preferred shares shall be adjusted (as of the original time of issuance), with or without the agreement of the holder, pursuant to the provisions of this clause to reflect the redetermined fair market value, and all necessary adjustments, payments and repayments as may be required shall forthwith be made between the proper parties

B. Attribution Rules

There are a number of provisions in the Act which deem that a taxpayer has received income or a capital gain which in law has actually been received by another person. If applied, these provisions could frustrate the planning goals of an estate freeze.

- **Personal Attribution Rules** – Sections 74.1, 74.2 and 56(4.1) – Generally, these apply to income, losses, capital gains, and capital losses connected with gifts or loans from a taxpayer to a spouse, and to income and losses (not capital gains and capital losses) connected with gifts or loans to a non-arm’s-length minor. The application of these rules can be avoided by properly structuring the estate freeze so that there is no gift or transfer by the parents. Where these rules might otherwise apply, the growth shares should always be subscribed for directly from the freeze corporation and value paid by the freeze beneficiary. Usually, the value paid for the shares by the beneficiary of the freeze will have a nominal value, but it is important that the consideration actually be paid by the beneficiary from his or her own resources to prevent attribution. Note as well that the validity of the share issuance may be placed in doubt if this consideration is not actually paid – see ABCA, Subsection 27(3).

- **Trust Attribution Rule** – Section 74.3 -- Similar to Section 74.1 and 74.2, these rules apply when a taxpayer seeks to benefit persons of the kind identified within the relevant rule using a trust. Where a freeze is made in favour of a family trust which includes a spouse or minor child as a beneficiary, the growth shares should always be subscribed for from the freeze corporation and value paid by the trustees on behalf of the Trust. Where a trust has just been constituted and does not have assets of its own, it is important that the Trust arrange a *bona fide* loan from someone other than the parents to finance the purchase of the shares. The loan should specify a reasonable interest rate and be repaid as to both principal and interest when the Trust has funds on hand. This can happen after the completion of the freeze by way of a dividend paid from the freeze corporation to the Trust. If the loan used to purchase the shares is made from a non-arm's length person, note that there is a requirement that interest at the prescribed rate be paid no later than January 30th of the year following its advance[34].
- **Corporate Attribution Rule –** Section 74.4 **–** Where a loan or transfer is made by an individual to a corporation, and where one of the main purposes of the loan or transfer can reasonably be considered to have been to reduce the income of the individual (including taxable capital gains), or to benefit a spouse, a non-arm's length minor, or certain other related minors, the individual may be liable to be assessed with a benefit as provided in the provision. This will result in double taxation, since the assessment of the benefit does not result in any tax relief for the beneficiary of the freeze. The rule can apply in freezes implemented under Sections 85, 86 or 51, as they each involve a transfer to a

corporation. One of the more important exceptions to the rule is where the freeze corporation is a small business corporation[35], which requires compliance with the 90% active business assets test. If the freeze corporation ceases to qualify at any time in the future (which is a risk if there is any build-up of redundant cash in the corporation, or if the corporation sells its business assets), corporate attribution will apply from that point onwards. Special steps can be taken to exclude section 74.4 (including in the case of a freeze to a family trust, placing a clause in the trust deed that prevents distributions to the type of person mentioned above). A method which is being used to avoid the application of the corporate attribution rule is implementing the freeze through a stock dividend (discussed above), which does not involve a transfer of property to a corporation.

- **Trust Reversion Rule** – Subsection 75(2) – This rule could be applied where a freeze has been executed in favour of a family trust. If certain events have occurred which taint the Trust for purposes of this provision, it could result in attribution of income and losses, and capital gains and losses to the parents, and also prevent later tax-deferred rollout of assets from the Trust as a result of Subsection 107(4.1) of the Act. Attribution will apply generally if property held in a trust is held on the condition:
    - That the property or property substituted therefor may
        - **Revert** to the person from whom it was directly or indirectly received, or
        - **Pass to persons** determined by that person at a time subsequent to the creation of the trust; or

- That during the existence of the person, the property shall not be disposed of except with the person’s consent or in accordance with the person’s direction.

The gist of the provision is that if a person put property in a trust and does not relinquish control to a trustee whom he or she does not control, the person will be required pay any tax that arises from that property. One way to avoid the application of this provision against the parents in a freeze would be to exclude them from being trustees or beneficiaries of the family trust. However, that would defeat several of the planning goals discussed above. So instead, care is taken to ensure that:

- Neither of the parents should act as the settlor of the Family Trust. As mentioned above, another family member (who is not included as a beneficiary of the Trust) or a friend should be asked to settle the Trust, with his or her own resources, which must never be reimbursed.
- None of the property being acquired by the family trust (most importantly in an estate freeze, the growth shares of the family corporation) is to be acquired from the parents. As with other planning to avoid application of attribution provisions, the Trustees must acquire the growth shares by direct subscription from the corporation and pay for them with resources of the trust, including a bona fide loan from an arm’s length party on reasonable commercial terms.

6. Protecting the Family Wealth

It is axiomatic that shares of a family corporation should never be issued directly to a minor child. A lawyer who has any doubt on this point should review Section 9 of the *Minors' Property Act* which contemplates an application to the Court where personal property of a minor child is proposed to be sold. One might reasonably expect that the Court will require the applicant to notify the Public Trustee if such an application were actually brought before it.

This problem can usually be avoided by holding shares that might ultimately vest in the child on attaining majority in a discretionary family trust. However, prior to distributing shares from a family trust to a non-minor child, consideration should be given to:

- Requiring the child and any spouse or domestic partner of the child to enter into a suitable domestic agreement which will limit claims against the family corporation shares in the event of a relationship breakdown
- Entering into a Unanimous Shareholder Agreement to trigger re-purchase of the shares in certain events, such as attachment by creditors, bankruptcy trustee, through a *Matrimonial Property Act* claim, or similar events.

Under the terms of Section 146 of the ABCA, the rules enacted in the USA will bind those who become shareholders through a rollout from the family trust.

A. Family Law Considerations

In a situation involving placing growth shares in the hands of a child (as opposed to a family trust, where the Trust Reversion Rule in Subsection 75(2) might apply, as discussed above), a simple method of limiting the exposure of a recipient of growth shares to future matrimonial property claims, and one which is often overlooked, is to forego the direct subscription for shares by the child. Instead of having the child subscribe for the shares from the freeze corporation, the parent can make the subscription, have the shares issued in his or her name, and then gift them to the child. The gift can be documented by way of a deed of gift, making it clear the shares are being transferred to the child without consideration.

As long as the child is of the age of majority, the income tax attribution rules will *not* apply to re-direct future dividends to the parent. However, these steps will ensure that the shares will not form part of the property in respect of which the presumption of equal sharing in subsection 7(4) of the Alberta *Matrimonial Property Act*[36] applies. Gifts are specifically excluded under subsection 7(2). This is a simple way to add extra security to a family estate freeze[37].

7. Conclusion

It can be seen that there are numerous technical legal and tax considerations to be weighed in the development and implementation of an estate freeze plan. These must be addressed carefully in conjunction with the client's other professional advisers.

However, effective advice to a client on an estate freeze requires more than an understanding of tax and corporate rules. It is vital to understand fully the client's wishes from an estate, succession and family planning perspective. There is no substitute for taking the time to get to know your client's business and family goals. As always, listening is one of the most important skills of an effective lawyer.

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[2] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), subsection 70(5).
[3] ITA paragraph 6(1)(a).
[4] ITA Section 7.
[5] See ITA Section 110.6.
[6] See Louis, *Implementing Estate Freezes,* Chapter 5.
[7] David Louis, Samantha Prasad and Michael Goldberg, *Tax and Family Business Succession Planning* (3rd ed.) CCH 2009, p. 20.
[8] ITA, Subsection 248(1).
[9] ITA, Subsection 69(1). Also refer to the various benefit provisions discussed later in this paper.
[10] ITA, Subsection 85(1).
[11] ITA, Subsection 110.6(2).
[12] ITA, Subsection 186(4). Generally, two corporations are connected when one holds shares of the other which represent in excess of 10 percent of votes and value associated with the issued share capital of the other.
[13] ITA, Subsection 112(1).
[14] KPMG LLP, "Combined Top Marginal Tax Rates for Individuals – 2012", Taxnet Pro, Corporate Tax Centre.
[15] See generally, KPMG LLP, *Understanding Section 55 and Butterfly Reorganizations* (3d.), CCH Canada Limited – 2010.
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[19] ITA, Subsection 84.1(2).
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[21] *Ibid.*
[22] ITA, Subsection 110.6(2.1).
[23] ITA, Subsection 110.6(1), definition of "share of a qualified small business corporation".
[24] *Ibid.* paragraph (b).
[25] ITA, Subparagraph 110.6(14)(f)(iii).
[26] Louis, *Implementing Estate Freezes*, p. 103.
[27] CRA Views 2010 – 0373271C6, APFF – 2010 Conference, Round Table on Federal Taxation, Question 7.
[28] CRA Views 9134555, "Estate Freezes".
[29] ITA, Section 120.4.
[30] ITA, Subsection 104(4).
[31] See ITA, Section 256, and related provisions.
[32] "Revenue Canada Round Table," in Report of Proceedings of the Thirty-Second Tax Conference, 1980 (Conference Report, Canadian Tax Foundation 1981), Question 13 at 602; quoted in Deloitte & Touche LLP and Fraser Milner Casgrain LLP, *Taxation of*

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[34] ITA, Subsection 74.5(2).

[35] ITA, Subsection 74.4(2)(c).

[36] R.S.A. 2000, c. M-8.

[37] See Stephen M. Grant, "Estate Freezes in the Family Law Context – The Big Chill Revisited", 22 Canadian Family Law Quarterly (2004) for a good discussion of cases in this area and advantages of gifting growth shares. See also, Martin J. Rochweg and Krystle A. Ng-A-Mann, "Freezing, Thawing, and Re-Freezing: The Intricacies of an Estate Freeze", Canadian Tax Foundation, 2009 OC, p. 12:27 – 29.