The Estate Freeze:
Old Tools Revisited

In the next 10 years or so there will be a significant transfer of wealth occurring as a younger generation gets set to inherit business, real estate and other investment assets.

Of course, Canada Customs and Revenue Agency (CCRA) will also be anxiously waiting to benefit from the considerable tax revenue windfall, as the transfer of these assets ultimately triggers a deemed disposition immediately prior to death, with resultant tax payable on the capital gains.

Historically, an "estate freeze" has always been an effective tool in limiting and quantifying the tax payable on such appreciating assets. Estate freezing attempts to minimize the tax by ensuring that the value of the taxpayer's estate will not increase after the freeze is implemented. If the estate freeze is properly implemented, the maximum amount of any capital gain arising on death and the resultant tax thereon should be relatively predictable.

There are a number of reasons why a freeze may be attractive and a number of situations in which a "freeze" can be implemented. For instance, consider:

1. Transfer of the family business to other family members to effect an orderly transition and deal with ownership succession;

2. Transfer of other assets not ordinarily divisible amongst beneficiaries such as a cottage, a commercial rental property or an interest in a business or partnership;

3. Crystallization of the $500,000 lifetime capital gains exemption;

4. The certainty of quantifying the deferred tax liability on death and providing liquidity through life-insurance funding; and

5. Shifting riskier growth assets to younger family members with a longer time horizon, thereby managing the age/risk profile.

Let's review a number of alternative methods of creating an "estate freeze":

1. <u>A Simple Sale</u>

At its simplest, a taxpayer could sell an appreciating asset to the intended family member or members in exchange for a non-interest bearing note, repayable on demand. The taxpayer now holds only the note which will not increase in value; the family member holds the appreciating asset.

This simple freeze, however, creates a number of problems:

– An effective loss of control over the asset;

- A potential income attribution problem if the recipient is a minor or a spouse;
- A deemed disposition of the asset for tax purposes with tax payable on any capital gains; and
- A potential funding problem on the note for the recipient.

Of course, if the tax payer has unutilized capital losses available, a sale at fair market value today may be an effective means of effecting the "estate freeze" with no immediate tax cost.

2. Sale or Gift to an Inter-Vivos Trust

The control issue to the "freezor" can be addressed by effecting a transfer or sale of the asset to an inter-vivos trust. The taxpayer can then exercise control over how the property is used by:

- The selection of trustees;
- The restriction of trustee powers specified in the trust document; and
- The reservation of powers by the transferor in their capacity as settlor. (This provision is subject to the Paragraph 75(2) of the Act and the negative consequences of attribution, should too much power be reserved by the Settlor.)

However, attribution of income from the property held by the trust will still be a factor, as subsection 74.1(2) of the Act specifically contemplates transfers to an infant by way of a trust.

Consequently, the use of a trust alone as a means of effecting an estate freeze will generally only be appropriate where the property currently has little or no accrued capital gain or where the property is "exempt" from tax. For instance, a taxpayer wishing to transfer an appreciating cottage property may be able to utilize the full principal residence exemption and transfer the property to a trust at current fair market value without creating a tax consequence.

3. Holding Company Freeze

By incorporating and transferring growth assets to a holding company, it is possible to:

- Freeze asset values;
- Avoid income attribution;
- Defer taxation;
- Maintain control; and
- Transfer future appreciation to the next generation.

The provisions of subsection 85(1) of the Act apply to a permit a tax-deferred rollover from a taxpayer to a "taxable Canadian corporation" of certain eligible property, including capital property (depreciable or non-depreciable), inventory (excepting real property), resource property or eligible capital property in exchange for consideration which includes shares. If an appropriately prepared election is filed with CCRA, the realization of capital gains can be deferred.

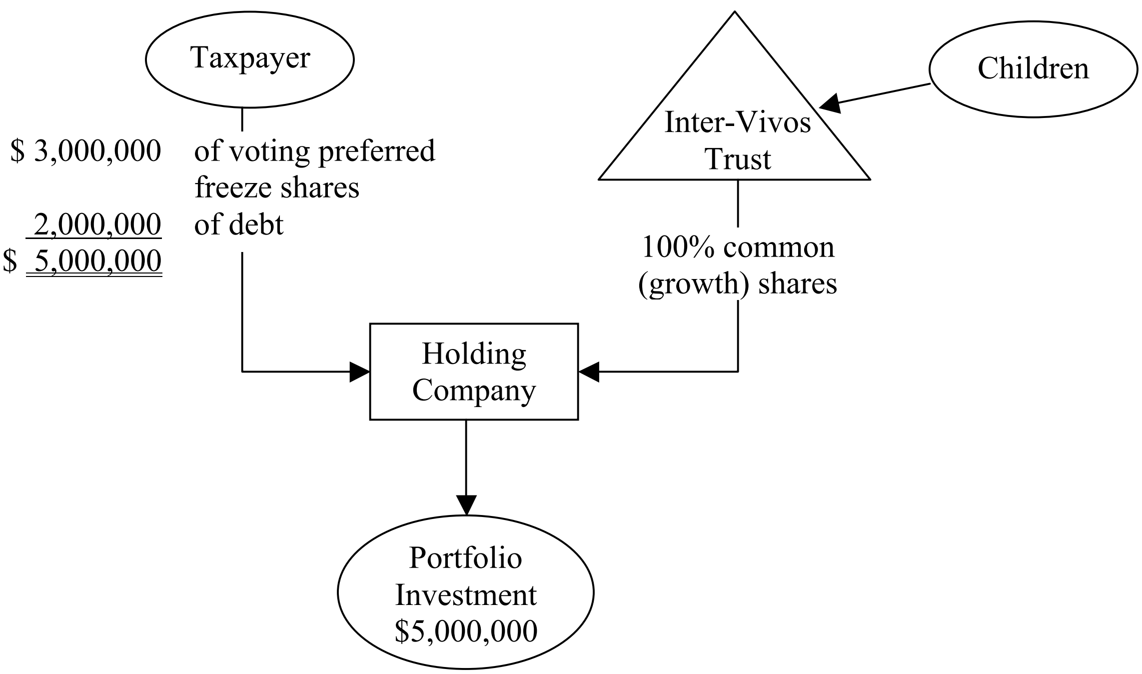
Consider the following example:

A taxpayer holds a portfolio of marketable securities with a potential for future appreciation:

FMV of	$	5,000,000
ACB of	$	2,000,000

An estate freeze in favour of a holding company could be implemented, with the common shares of the holding company owned by an inter-vivos family trust. Consideration issued by the holding company would include voting preferred "freeze" shares issued to the taxpayer, thereby ensuring that the taxpayer retains voting control over the corporation.

Care should be taken to ensure that the provisions of paragraph 85(1)(e.2) will not apply to deem a benefit to have been conferred on a person related to the freezor. For this reason, it is imperative that valuation of the property and consideration received by the transferor be appropriate.



Benefits

- Effective freeze of taxpayer's assets at $5,000,000 value;
- Capital gains tax deferred;
- Future growth in portfolio accrues to Inver-vivos trust;

- Ability to recover refundable dividend tax on hand (RDTOH) on payment of taxable dividends to Trust; and
- Income attribution issued can be managed.

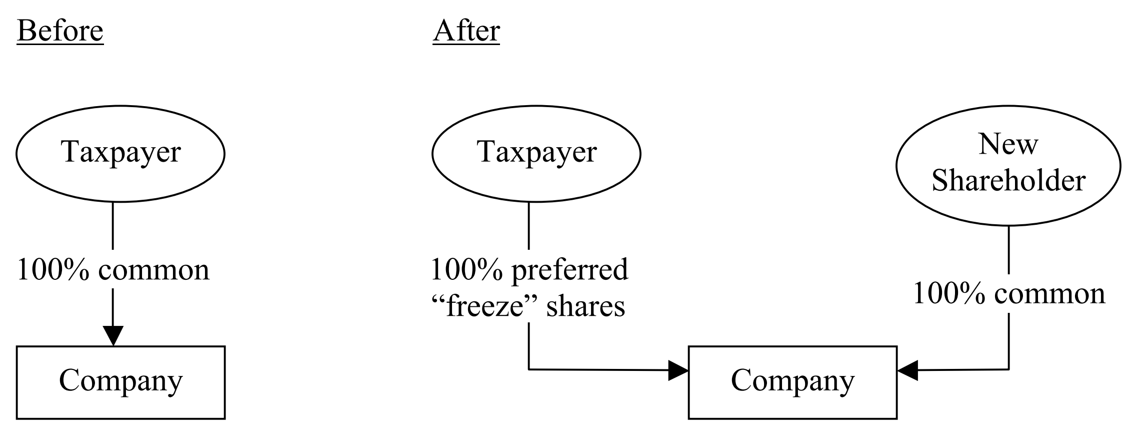
4. <u>Section 86(1) Reorganization of Capital</u>

As estate freeze can also be achieved by means of a Section 86(1) Reorganization of Capital within the corporate structure.

A new holding company is not required; the existing capital of the corporation can be reorganized by exchanging (on a tax-deferred basis) all of the common shares of the corporation for non-participating preferred "freeze" shares having a value in aggregate, equal to the value of the "old" common shares so exchanged.

The transfer of the future growth in the corporation is achieved by issuing "new" common growth shares to the intended recipients.

A Section 86(1) Reorganization is a useful and direct means of introducing new ownership into the company and in providing value and control to the "freezing interest". This method is preferable where the new owners are directly involved and active in the existing business.



Of course there are pitfalls which must be considered when implementing a Section 86 freeze. Subsection 86(2) can apply where a benefit can reasonably be considered to have been conferred on persons related to the taxpayer as a result of the reorganization.

Valuation of the "old" shares and consideration received by the freezor are crucial elements to ensure that the freeze is appropriately implemented.

<u>Benefits</u>

- Taxpayer retains control over company;
- Direct ownership for new shareholder; and
- Eliminate potential for double taxation of capital gains inherent in holding company freeze.

5. Section 51 Conversion

This method of "estate freezing" requires the existence of a right to convert growth shares into shares of a different class such as preferred "freeze" shares. If such a right does not exist, it can be created by an amendment to the Articles. Section 51 does not require that the shares be convertible under their existing terms and conditions. Therefore, provided that the shares are capital property, Section 51 should apply as a default provision to ensure that a rollover occurs in circumstances where amendments to the terms and conditions of a share might be considered to otherwise create a disposition.

Section 51 operates where a right is exercised to convert the common shares of a company (for instance) into preferred shares. The exercise of a right is not considered a disposition of the shares, and the new preferred shares will have an ACB equal to the old common shares prior to the conversion.

There is no "opting out" of Section 51 by electing to recognize a gain. In contrast to a Section 85(1) rollover, Section 51 reflects a "conversion" of one class of shares to another by virtue of the conversion right.

The Section 51 conversion has the advantage of permitting a partial "freeze" of the taxpayer's common shares. However, the freezor can receive no consideration other than the acquisition of the new shares.

Summary

There are obviously a number of "Estate Freeze" alternatives and an array of issues facing the professional estate planner. However, the existing legislation provides the professional estate planner with many effective tools to accomplish his client's needs. The "old tools" still work and should be re-visited with some imagination and application for our client needs.