THE ESTATE FREEZE

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The Estate Freeze

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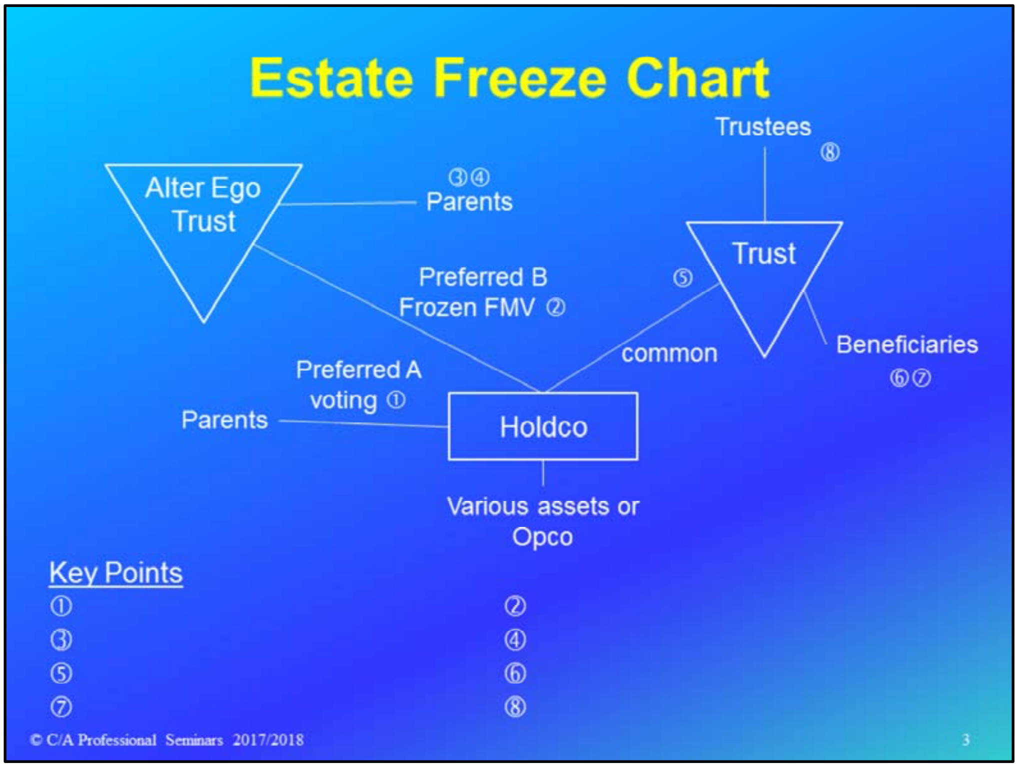
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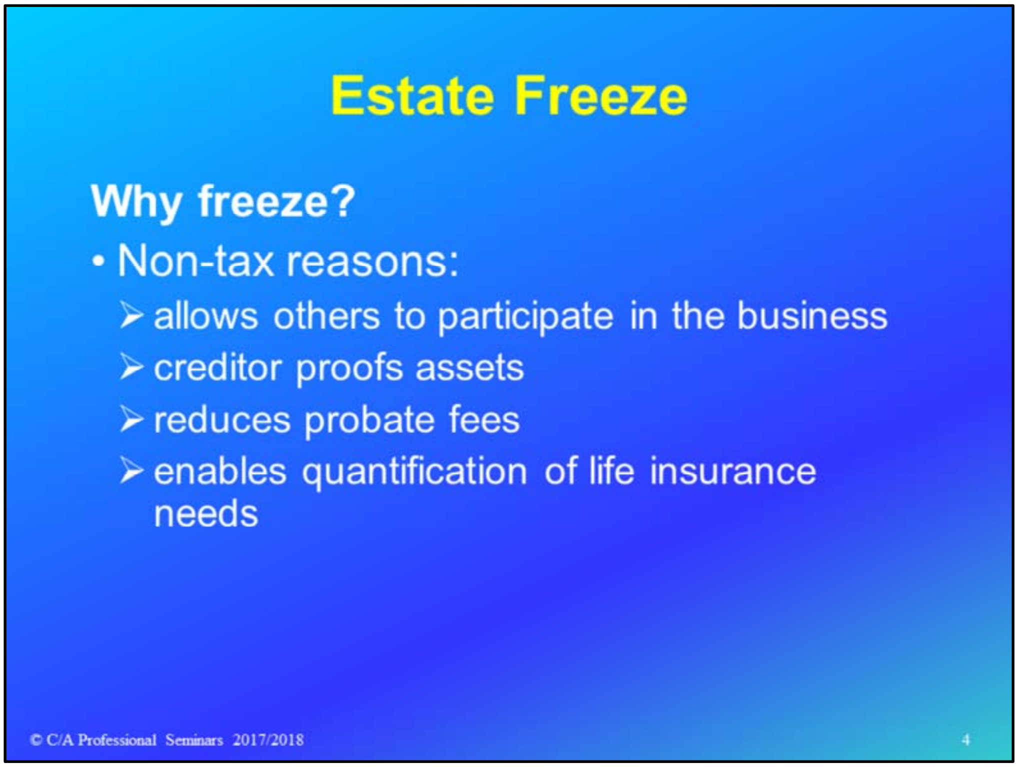


An estate freeze usually refers to a transaction or series of transactions entered into by an individual to ensure that any future increases in the value of his/her property will accrue in whole or in part to other persons, usually chosen family members, or trusts.

Although an estate freeze is normally conducted for income tax purposes, there are many other reasons for implementing a freeze. Some of the more common non-income tax reasons for a freeze include:

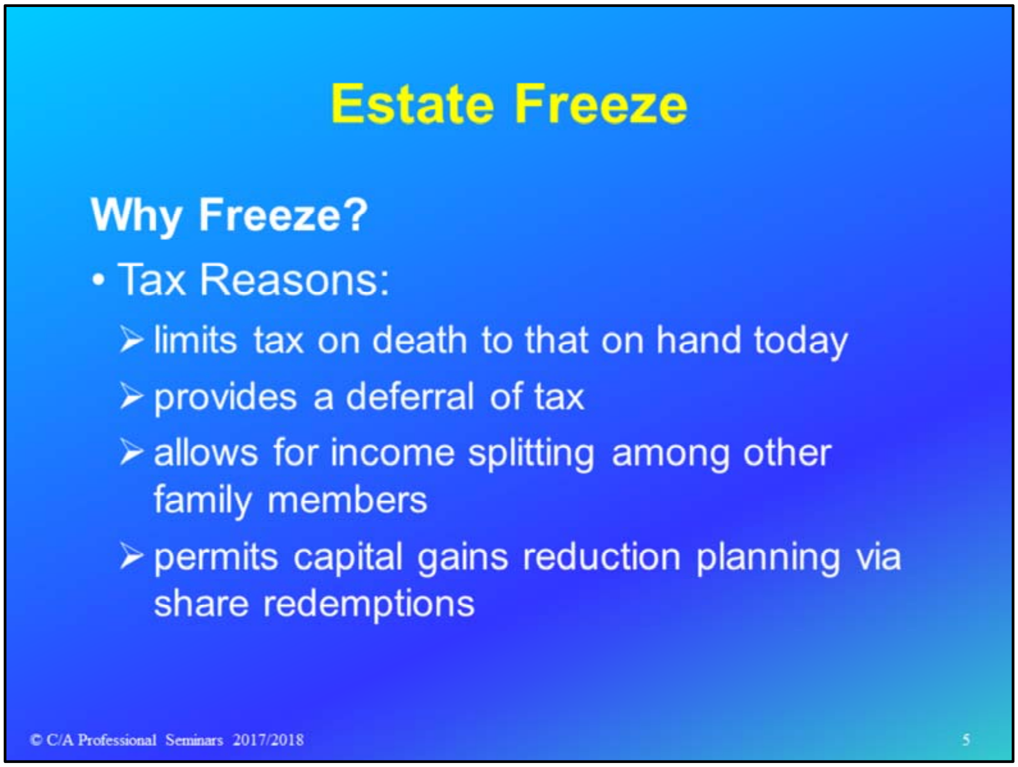
- participation in the growth of a business by spouse, children or key employees
- creditor proofing of assets
- reduction of probate fees
- U.S. estate tax planning
- quantifying the freezor's life insurance needs

An estate freeze allows others to participate in the business by freezing the current value of common shares, and then allowing a subscription by others for new common shares at nominal value. This allows others to participate in the business without requiring a significant cash or loan investment by the other persons.

An estate freeze also allows assets to be creditor-proofed in that the future growth of a business, for example, will accrue to other new common shareholders (perhaps trusts).

An estate freeze allows for a reduction in probate fees in that the value of the shares are fixed.

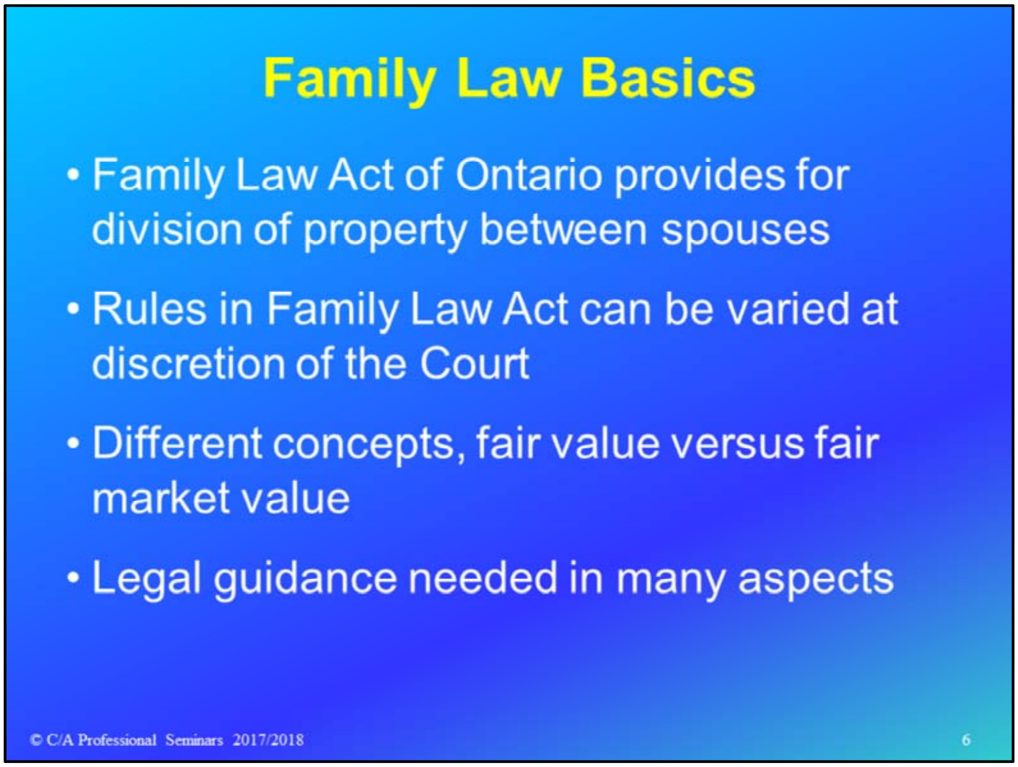
Finally, an estate freeze enables one to quantify their life insurance needs.



For income tax purposes, the estate freeze limits the capital gains that would occur on death to the gain on hand today. It stops the gain from getting bigger. It can also be used to defer tax, by putting growth shares into the hands of the next generation or a family trust. It can be used in conjunction with a family trust for income splitting purposes. In fact, this is a fundamental income splitting approach.

An estate freeze can also be used to introduce new shareholders for purposes of claiming the capital gains exemption.

Lastly, an estate freeze can allow a sequence of share redemptions which can actually reduce the capital gains tax.



Three main times/situations when the Family Law Act is relevant are:

Estate planning and family financial planning (i.e., structuring the estate to avoid the spouse obtaining property);

Issues arising on separation; and

Issues arising on death.

In these situations you need to ask: Does the Family Law Act (Ontario) apply? Also consider Section 15/Conflict of Laws.

The Family Law Act is governed by internal law of the place where both spouses last had their communal residence.

The Family Law Act applies to spouses (married to each other) with respect to property division. It does not apply to common law relationships.

Polygamous marriages are recognized if marriage was in a jurisdiction which recognized such as valid.

Family Law Basics

Net Family Property

- The spouse whose net family property is less is entitled to half of the difference between the net family properties
- Net family property means the value of all property on the valuation date (date of separation or date of death) after deducting liabilities and property (other than a matrimonial home) owned by the spouse at date of marriage

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The following are excluded from net family property:

Property other than a matrimonial home acquired by gift or inheritance after marriage;

Income from such property if expressly stated;

Damages for personal injury, mental stress etc.;

Proceeds of a life insurance policy received on the death of the insured;

Any property which can be traced into the above listed sources;

Property which the spouses have agreed in a domestic contract is not to be included in net family property; and

Unadjusted pension earnings under CPP.

The matrimonial home cannot be protected from being net family property, even if received by inheritance, owned before marriage, or specified in marriage contract. The matrimonial home is a home occupied by the person and his/her spouse as a family residence at the time of separation. There can be more than one matrimonial home (house and cottage for example) and the matrimonial home can be outside of Ontario and outside of Canada.

Family Law Basics

Net Family Property

- Onus of proof on excluding property from net family property is on the person claiming that it should be excluded

Example

John and Jane were married in 2010. John had $200,000 and Jane had $100,000 of net assets entering the marriage.

Jane received $400,000 by inheritance.

At January 1, 2017, the date of separation, John had net assets of $600,000 and Jane had net assets of $300,000.

$400,000 of Jane's inheritance is excluded from the figures above.

John's increase in net family property is $400,000 (i.e., $600,000 - $200,000).

Jane's increase in net family property is $200,000 (i.e., $300,000 - $100,000).

As a result, John owes $100,000 to Jane (i.e., ½ of: $400,000 - $200,000).

Note Jane's net worth is $700,000, which is $100,000 more than John's. Yet she still gets $100,000 from John.

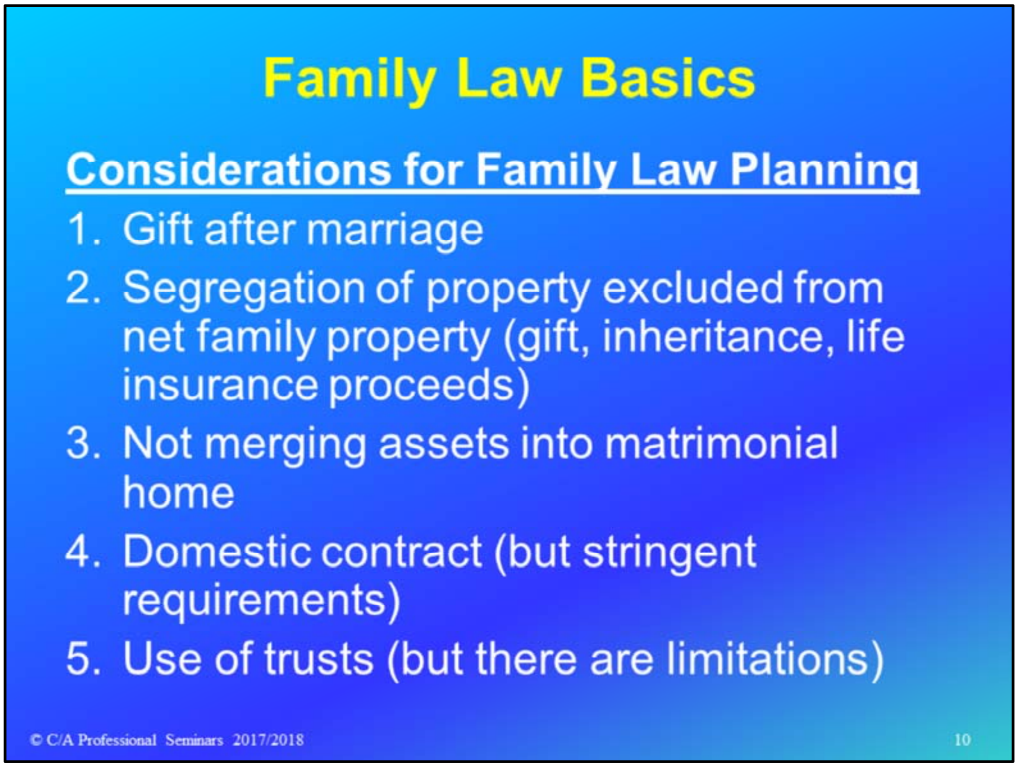
Family Law Basics

Issues At Death

- When one's spouse dies, if the net family property of the deceased spouse exceeds the net family property of the surviving spouse, the surviving spouse is entitled to half of the difference
- Surviving spouse shall make an election to receive half of net family property difference within six months after first spouse's death. Otherwise, election deemed not to be made
- During first six months, no distributions can be made from the estate except with spouse's consent or court's consent

The division of assets on death follows the same rules as on separation but requires an election.

On property division, the court can order that specific properties be distributed to each spouse. The intent is to minimize disruption to the family (for example husband gets the business, wife gets matrimonial home and investments).



The Family Law Act has specific rules for domestic contracts.

Also the Family Law Act has extensive rules which govern spousal support and child support.

Many people do not care about Family Law issues, until the problems arise, and then it is too late.

Gift after marriage is a powerful planning technique, but much is unknown as to what will be accepted.

For example, with an estate freeze, the issuance of new common shares to the father with a gift to a son, might be set aside by a court. What about a re-freeze just before son get's married?

It can be hard to get definitive advice.

Sometimes, the planning comes down to "better off to do it than not to do it", whether it ultimately works or not.

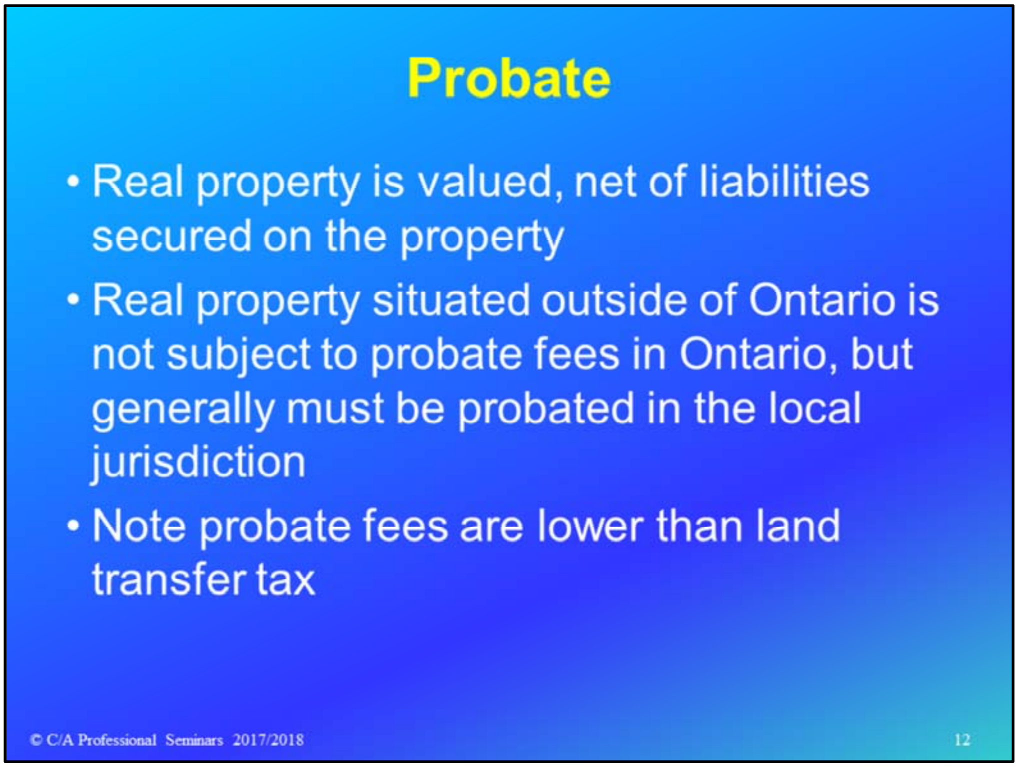
Many Family Law disputes are settled through negotiation and mediation, rather than through the court process.

Probate

- What is probate?
  - process by which the Will is legally approved by the courts, and executors (estate trustees) are appointed to administer assets of the deceased (become legal owner)
- Probate fee rate varies, depending on province
  - in Ontario 0.5% on first $50,000, 1.5% thereafter
- Probate fees are payable when assets of a Will are probated

Probate is the process by which your Will is legally approved by the courts under provincial legislation. It also refers to the required documentation as set out by provincial legislation and confirmed by the courts, and includes legal confirmation of the appointment of the executor. Although not all Wills have to be probated, many regulatory or government agencies and banks could refuse to recognize the executor's authority unless the Will was validated by the court.

Probate fees vary depending on which province the person resides, and as well on where property is located. In Ontario, the rate is 0.5% on the first $50,000 and 1.5% thereafter. Where one asset in the estate requires probate, then all of the assets governed by that particular Will must be probated and are subject to probate fees.



Real property is valued at market value net of liabilities secured on the property. Real property situated outside of Ontario is not subject to probate fees in Ontario, but generally will be subject to probate in the province in which the property is located.

Probate

Planning to minimize probate fees

- multiple Wills, probate one not the other
- holding property jointly with a right of survivorship
- having named beneficiaries on RRSPs, life insurance policies
- transfer to trust during lifetime

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In Ontario, there is no maximum on the amount of probate fees payable. Probate fees can be minimized by having multiple Wills. One Will could govern the distribution of assets which are subject to probate, and another Will could govern the distribution of those assets not subject to probate.

Another method in which probate fees could be minimized is by having property registered jointly with a right of survivorship. In this way, the property automatically passes to a surviving person on the death of the joint owner. Naming beneficiaries on RRSPs, life insurance policies and bank accounts is another method in which probate fees could be minimized.

One must be mindful that there could be a deemed disposition on changing the registration of a property from one tenant to joint tenancy. This could be the case where property is held jointly with children. In addition, if children own a portion of a principal residence, that portion may not qualify for the principal residence exemption. These immediate tax costs should be balanced against the amount of probate fees that could otherwise be saved.

Also assets may be transferred to trusts during life to avoid probate fees.

Transfers to Trusts

Transfer to a trust occurs at FMV unless trust is:

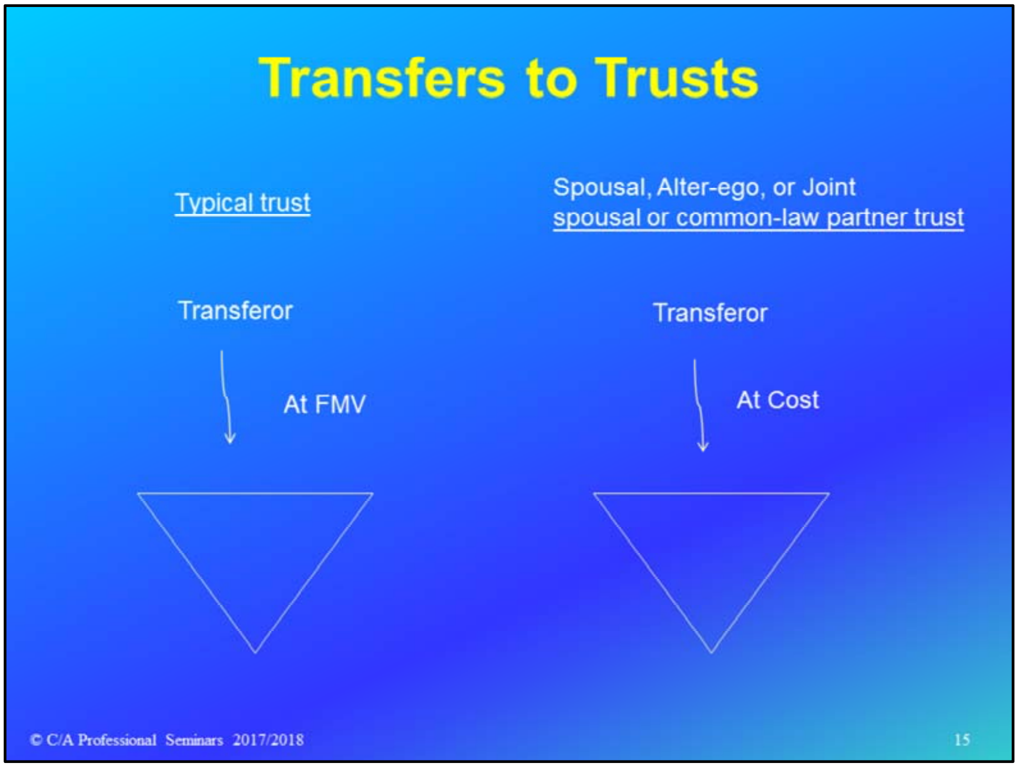
- Spousal trust (including common-law partner) – spouse is beneficiary
- Alter-ego trust – contributor is beneficiary
- Joint spousal or common-law partner trust – spouse and contributor beneficiaries

Then transfer occurs at tax cost unless elect for FMV to apply

A transfer to a trust will normally occur at fair market value.

The exceptions are where the trust is a spousal trust, an alter ego trust or a joint spousal or common-law partner trust. For the transfer to occur at cost, rather than fair market value, the transferor and the trustee of the trust must be resident in Canada. Then, the transaction will automatically take place at tax cost unless there is a joint election for it to take place at fair market value.

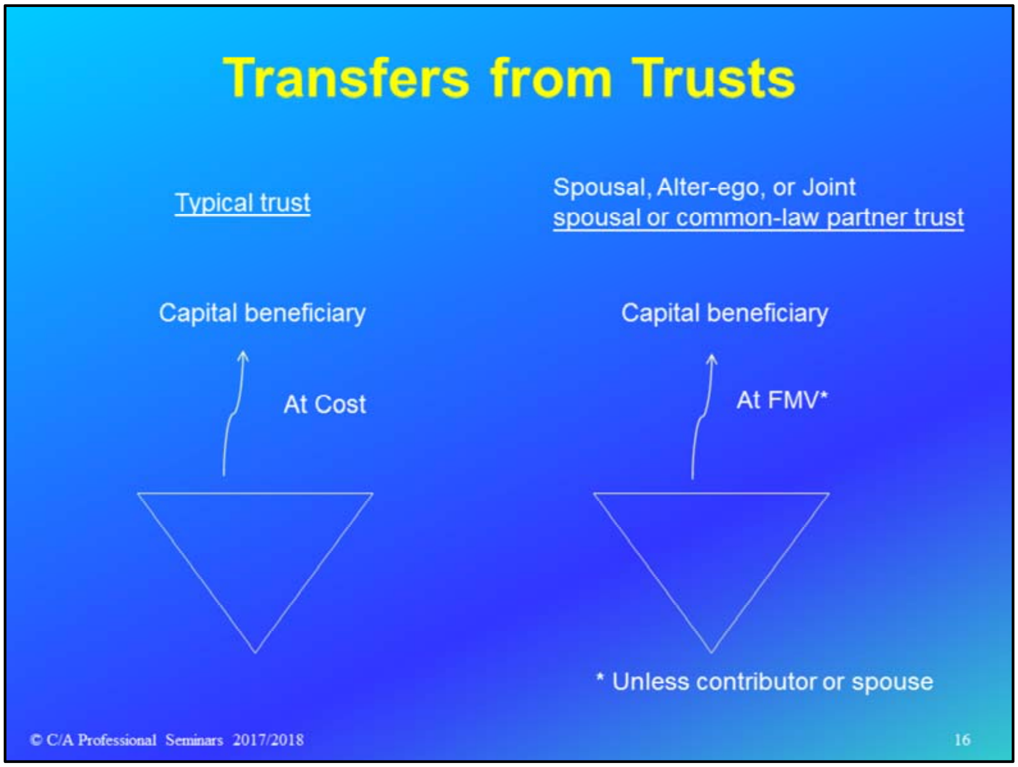
These trusts are useful for probate fee planning.



A transfer to a trust will normally occur at fair market value. Hence the disposition can trigger tax to the transferor.

With a spousal trust, an alter ego trust or a joint spousal or common-law partner trust the transfer occurs at cost (i.e., tax-free) as long as the transferor and the trustee are resident in Canada. An election is possible so that the asset is transferred at FMV.

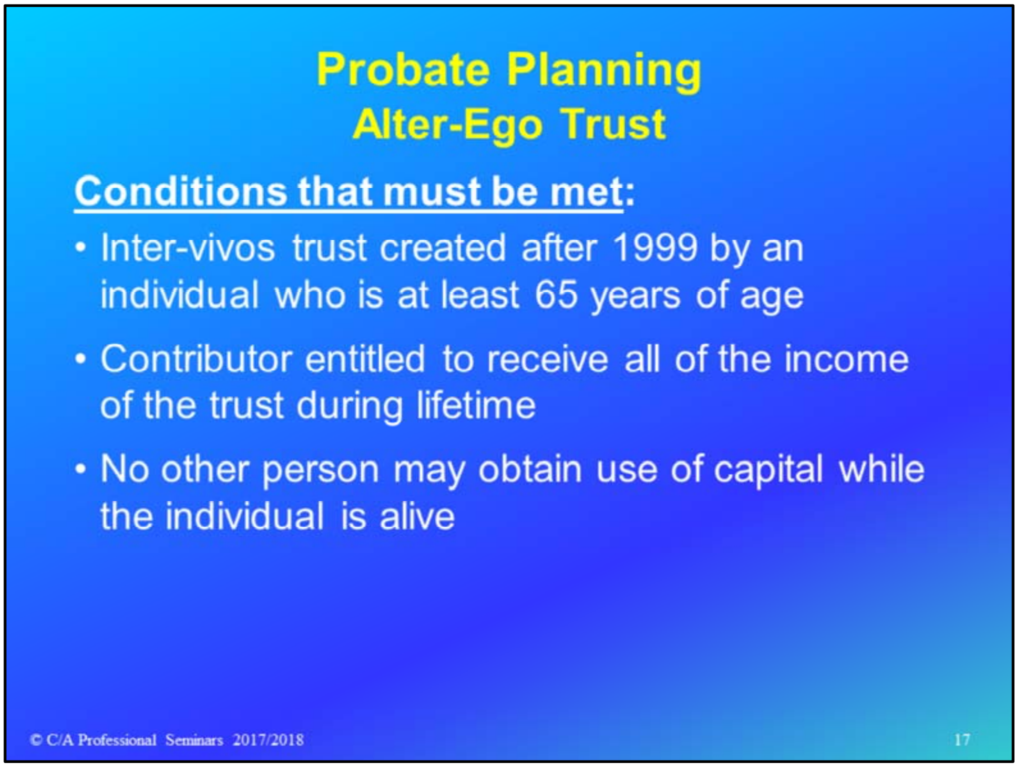
Note: with corporations and partnerships, assets can be transferred tax-free to the corporation (or partnership) as long as certain conditions are met (and an election is filed).



A transfer of assets (i.e., capital) from a trust to a capital beneficiary will normally occur at tax cost. Hence the disposition is typically tax-free.

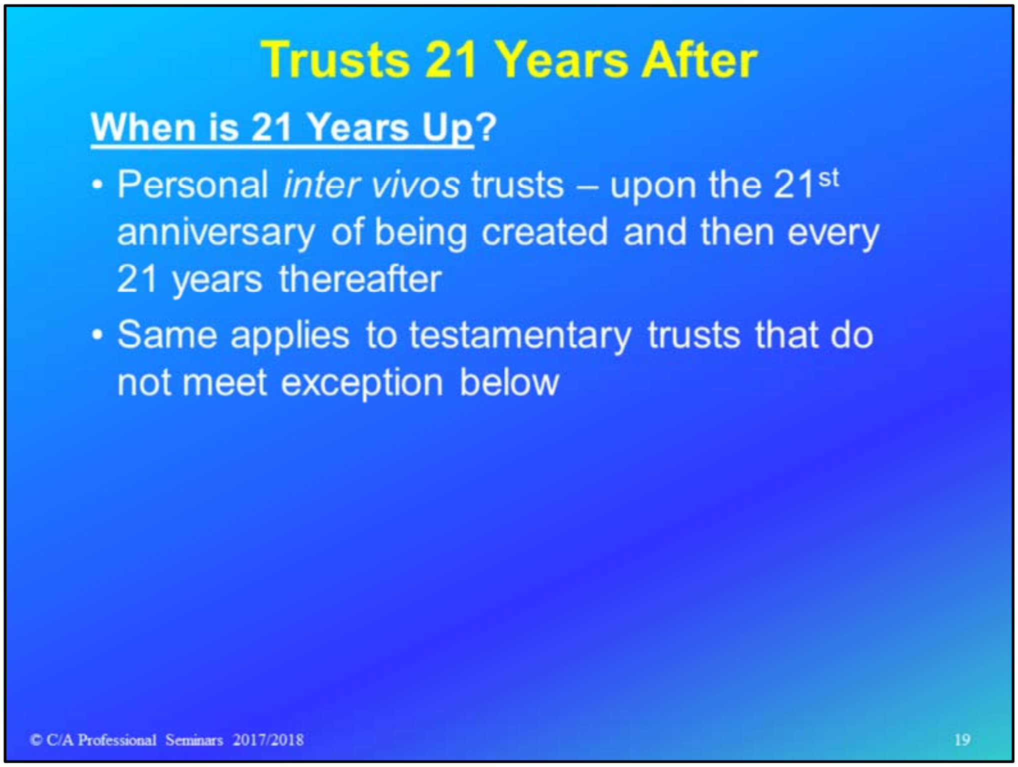
With a spousal trust, an alter ego trust or a joint spousal or common-law partner trust this rollover does not apply and the transfer occurs at fair market value unless made to the contributor or spouse (if a beneficiary). Hence the disposition can trigger income tax. (Note that these trusts require that no person other than the spouse, the contributor, the contributor and the spouse, respectively, be able to receive income or capital during their lifetime).

Note: with corporations and partnerships, when assets are transferred out the transaction is at fair market value (and income tax can be triggered).



An Alter-Ego Trust is an inter-vivos trust created after 1999 by an individual who is at least 65 years of age. To qualify as an alter-ego trust, the trust deed must specify that the taxpayer alone is entitled to receive all of the income of the trust that arose before the taxpayer's death, and no person except the taxpayer could, before the taxpayer's death, receive or otherwise obtain the use of any capital of the trust.

A Joint-Spousal or Common Law Partner Trust is similar to an alter-ego trust with the exception that under terms of the trust, the taxpayer or the taxpayer's spouse or common-law partner in combination, must be entitled to receive all of the income of the trust that arose before the later of the death of the taxpayer and the spouse or common-law partner. In addition, no other person may, before the later of those deaths, receive or otherwise obtain the use of any capital of the trust.



The clock starts ticking 21 years after the trust is constituted, generally being the day on which the three certainties are present and assets are initially settled into the names of the trustee. This day may or may not be clear, particularly when dealing with some testamentary trusts. Some Wills are structured such that a clear transfer occurs to demark the passage of assets from executors or administrators to trustees. So that the moment on which the trust comes into existence is clear and collaborated with a distinct paper trail. Others are not so clear. The conservative position in the event that the date of creation is not clear is to select the date of death as the date when the 21 years commenced.

There are a number of exceptions to the 21 years rule as pointed out above.

Trusts 21 Years After

Exceptions

- Testamentary spousal or common-law partner trust – upon the death of a beneficiary spouse and then every 21 years thereafter
- Alter ego trust – upon death of the contributor or settlor and then every 21 years thereafter
- Joint spousal or common-law partner trust – death of last surviving spouse and then every 21 years thereafter
- Deemed resident trust – upon ceasing to be resident in Canada for income tax purposes

The clock starts ticking 21 years after the trust is constituted, generally being the day on which the three certainties are present and assets are initially settled into the names of the trustee. This day may or may not be clear, particularly when dealing with some testamentary trusts. Some Wills are structured such that a clear transfer occurs to demark the passage of assets from executors or administrators to trustees. So that the moment on which the trust comes into existence is clear and collaborated with a distinct paper trail. Others are not so clear. The conservative position in the event that the date of creation is not clear is to select the date of death as the date when the 21 years commenced.

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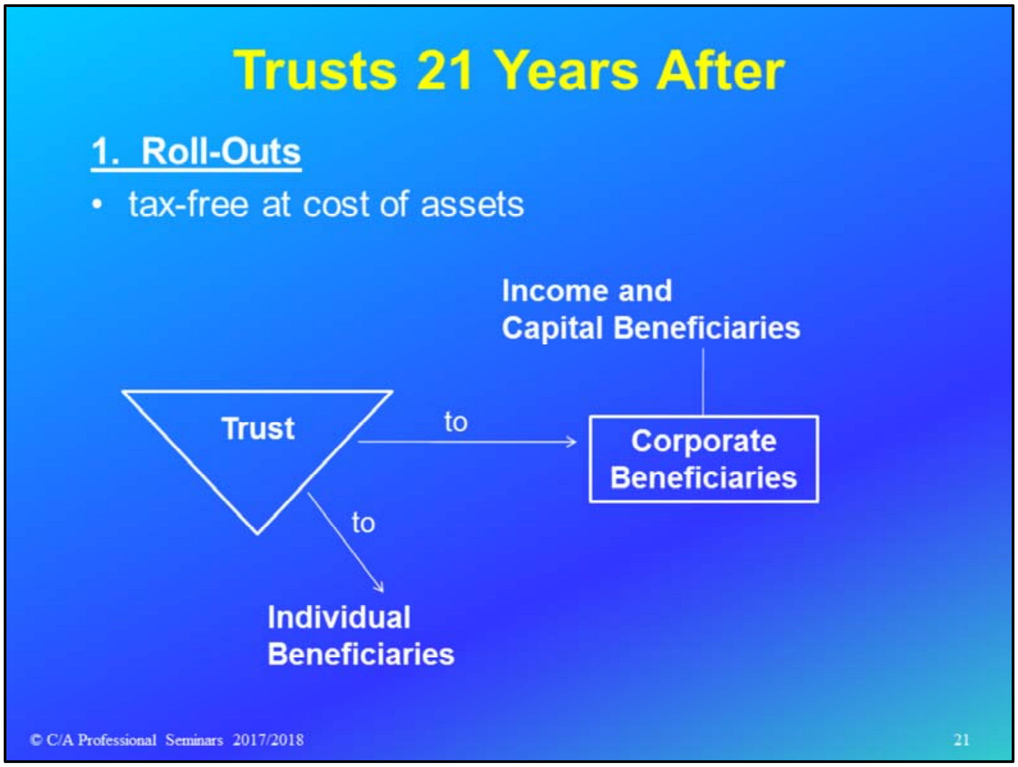
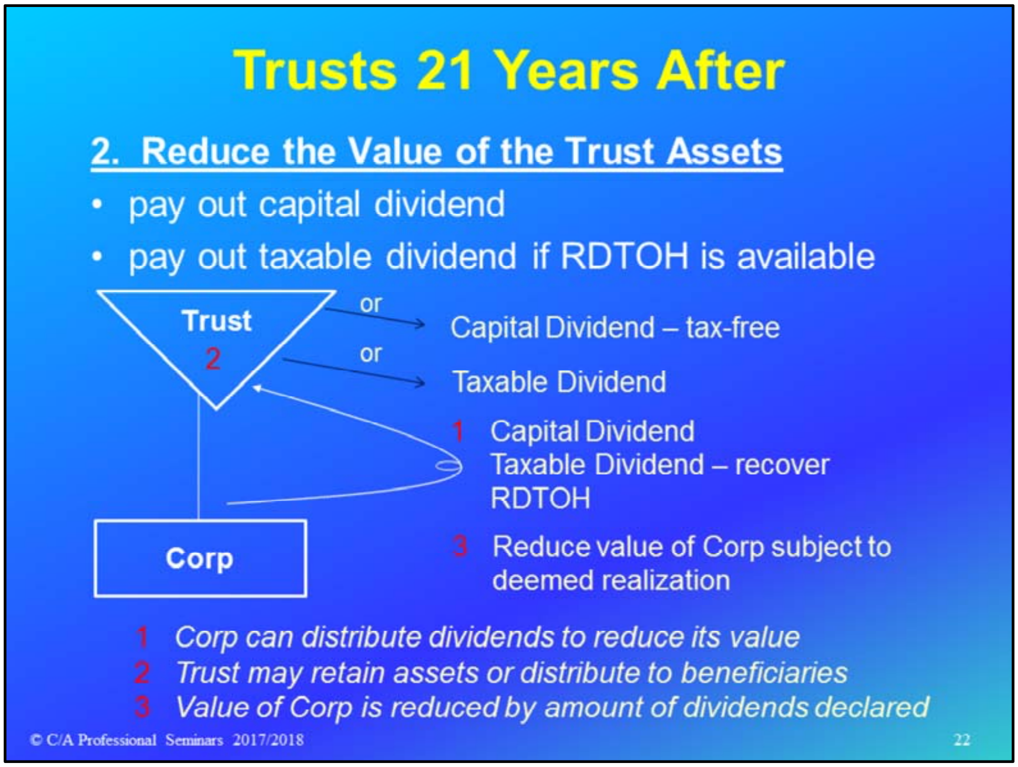


Where trust property is distributed to its capital beneficiaries on a tax-deferred basis, the trust is deemed to have disposed of its property at cost and the beneficiaries are deemed to have acquired the same assets at cost deferring tax to both the trust and its beneficiaries until such time as the property is sold. If these assets are subsequently transferred to someone else or the beneficiary has a deemed disposition either as a result of his/her own death or ceasing to be a Canadian resident, then the property is deemed to have been disposed of then.

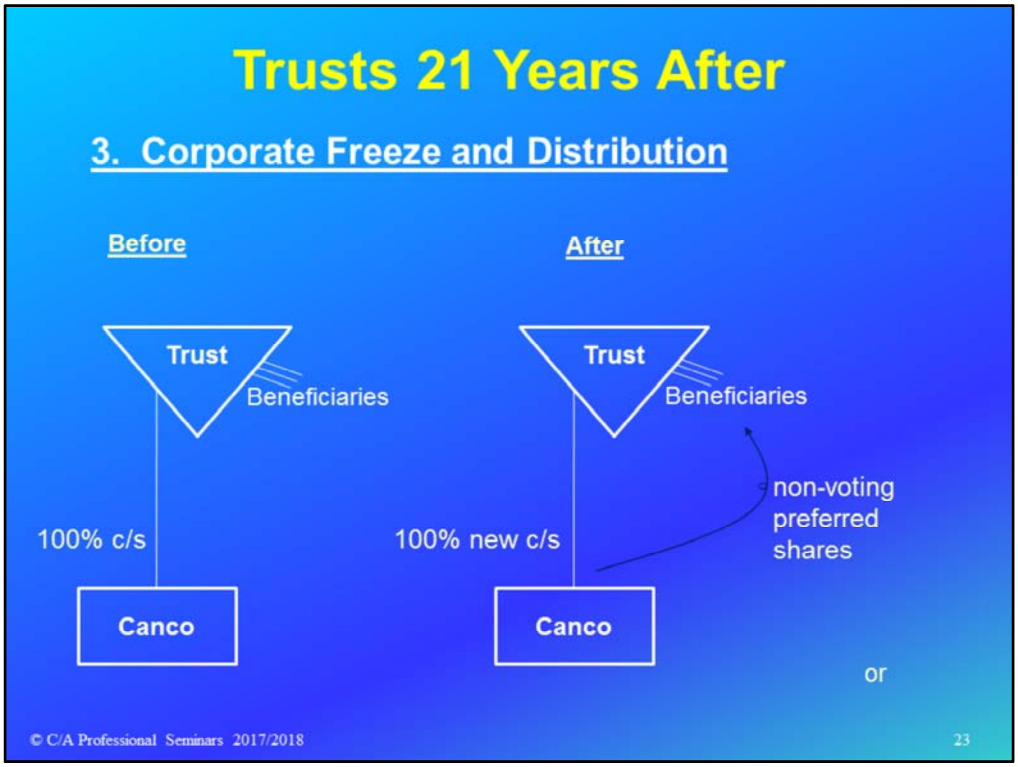
The "rollover" rules do not apply to all distributions. Exceptions include:

- If the trust or the beneficiary elects out of the rollover under 107(2.001) or 107(2.002)
- Property of a trust where subsection 75(2) has applied to the trust and the distribution is to a person other than the contributor or spouse, while the contributor is alive
- To a distribution subject to ss.107(5), namely, a distribution of property to a non-resident beneficiary (with limited exceptions)

In the above situations, the trust is deemed to dispose of the distributed property at its fair market value, resulting in potential taxes to the trust.



The payment of dividends will reduce the value of the shares owned by the trust and therefore the ultimate tax on the deemed realization. The advantages in this strategy are that the trustees can retain control over the trust assets and even decide to retain the dividend income within the trust, as opposed to distributing income to the beneficiaries, if desired. Also, there are no "even-hand" issues to contend with and such strategy will permit the trustees to continue to administer the trust assets, perhaps for an additional 21-year period.



In anticipation of the 21-year deemed disposition, the trustees may consider reorganizing the capital of the corporation so that the common shares owned by the trust are exchanged for preferred shares having a fair market value equal to the "old" common shares, and a low adjusted cost base for tax purposes. The preferred shares will be distributed to the capital beneficiaries prior to the 21-year deemed realization thereby avoiding the deemed disposition. A new class of common shares will be issued to the trust after the 21st anniversary or to a new trust which will benefit from the future growth of the corporation. The trustees, in this scenario, can retain control of Canco by the fact that it owns the voting shares in Canco.

Trusts 21 Years After

4. Do Nothing

- When want to preserve testamentary trust status and assets
- No significant gain to realize
- Have accrued losses that can be triggered to offset the gains
- Have no choice

If the deemed disposition rules apply and taxes result, the trust can elect under ss.159(6.1) to pay the tax resulting from a disposition of non-depreciable capital property and land inventory in up to 10 equal annual instalments but interest is charged. This provides some relief of tax burden, however, a trust cannot defer tax arising on a deemed disposition of depreciable property and resource property by making the election.

Alter-Ego/Joint-Spousal or Common Law Partner Trusts

Deemed Dispositions

- Deemed disposition date for alter-ego trust is end of day of death of transferor individual
- Deemed disposition date for joint spousal or common-law partner trust is the end of the day of the later of death of transferor individual and spouse or common-law partner
- If trust continues after death 21-year rule will apply 21 years later

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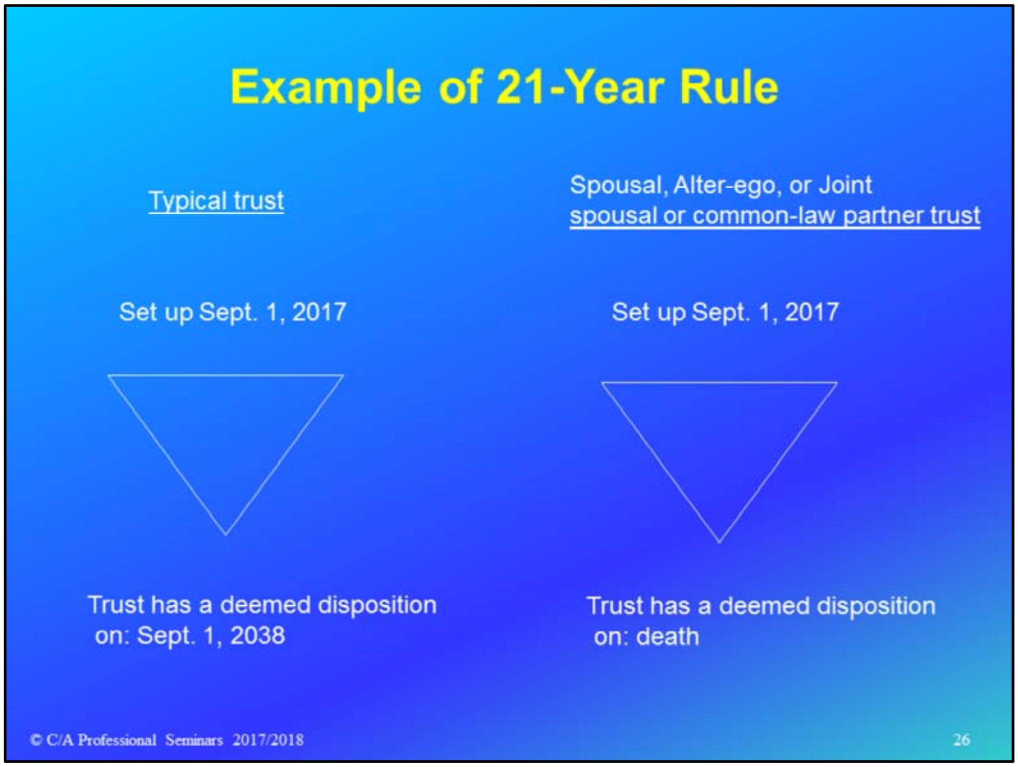
With an alter-ego trust, the 21-year deemed disposition rule is deferred until the death of the transferor individual. Therefore, it is possible to defer the deemed disposition beyond 21 years. For example, if an individual settles an alter-ego trust at age 65 and dies at age 100, the disposition of the assets of the trust will take place 35 years after the trust was settled.

But on death, there is a fair market value disposition. Rules equivalent to those of a spousal trust then apply.



Mr. A sets up a family trust for the benefit of his children on September 1, 2017 (i.e., typical trust). 21 years later, i.e., on Sept. 1, 2038, and every 21 years after that date, the trust has a deemed disposition of all of its assets at FMV.

With an alter-ego trust, the 21-year deemed disposition rule is deferred until the death of the transferor individual. For example, if an individual settles an alter-ego trust on Sept. 1, 2017, at age 65, and dies at age 100, the disposition of the assets of the trust will take place 35 years after the trust was settled. With a spousal trust, the disposition of assets will take place when the spouse passes away. With a joint-spousal or common law partner trust the deemed disposition will occur after the second spouse/partner passes away. On death, there is a fair market value disposition and if the trust continues on the 21-year rule applies thereafter.

Alter-Ego/Joint-Spousal or Common Law Partner Trusts

- On deemed disposition date, assets deemed disposed of at FMV
- Capital gains taxable by the trust at the highest applicable tax rate
- Deemed year-end at end of that day, with deemed disposition just before
- During life, income attribution to transferor of gains/losses/income

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Because an alter-ego trust is an inter-vivos trust, the deemed disposition by the trust upon the death of the transferor individual results in capital gains being taxable by the trust at the highest marginal tax rate. Graduated tax rates are not available. Therefore, careful tax planning is required to ensure that the trust does not face a higher tax burden on the deemed disposition of the assets than would be the case for the individual.

If, after the contributor individual dies, the trust continues, then the normal rules applicable to inter-vivos trusts will apply.

Income attribution does not apply to a deemed gain created on death for an alter ego, spousal or joint partner trust. Because the disposition is deemed to occur at the end of the day, the person by then is deceased. So attribution cannot apply.

Alter-Ego/Joint-Spousal or Common Law Partner Trusts

Where contributor taxpayer dies, and property left to a trust for benefit of deceased's spouse, new trust is not a testamentary trust

- CRA's view is that the newly created trust not testamentary trust because property of alter-ego trust does not belong to the settlor at time of his death
- loss of rollover opportunities to surviving spouse

Do not make the beneficiary of an inter vivos trust the person's estate. It will disqualify the estate as a GRE

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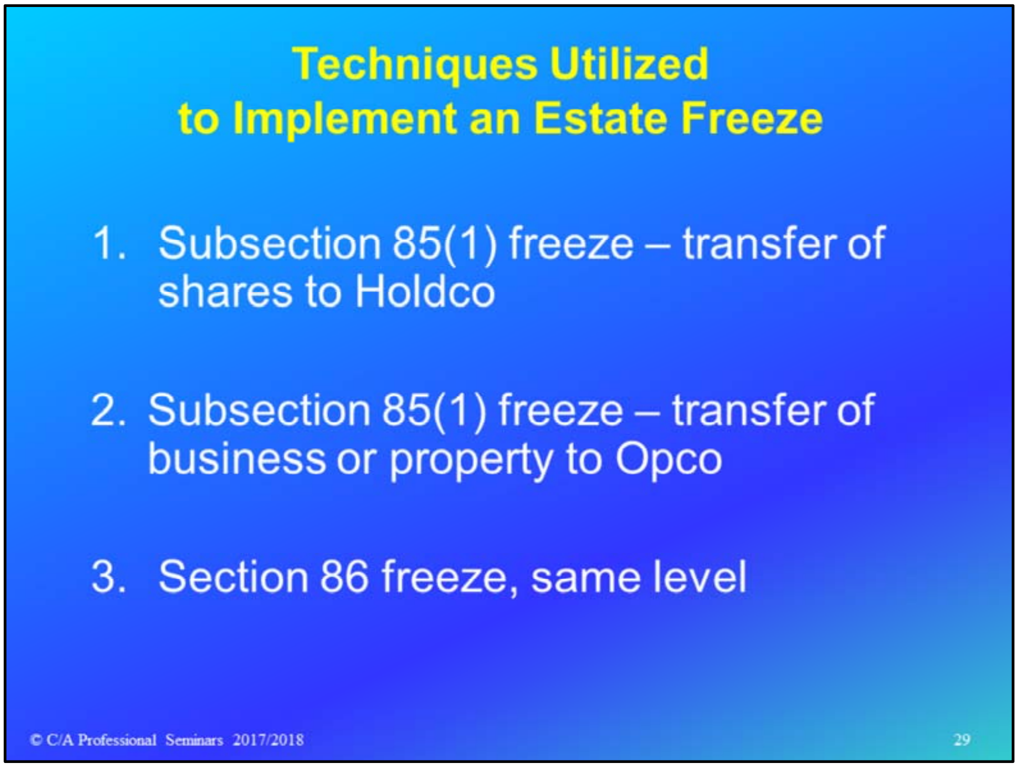
Note that an alter ego trust and a joint spousal or common-law partner trust are both inter vivos trusts. If the beneficiary is ultimately an estate, this will disqualify the estate as being a testamentary trust. As such, the estate will not be a graduated rate estate (GRE). There are serious adverse consequences to the estate not being a GRE.



Surprisingly, there are actually nine possible ways to carry out an estate freeze. Some of these ways are tax-free, some are fully taxable. While each of these proposed plans and arrangements are shown in detail in the pages which follow, it is not necessary to gain a complete understanding of every possible technique and application. Instead, what is important is to understand the main use of an estate freeze.

Techniques Utilized to Implement an Estate Freeze

4. Section 51 freeze

5. “Section 86 style” – Section 85 freeze

6. Gifts or sales – taxable freeze

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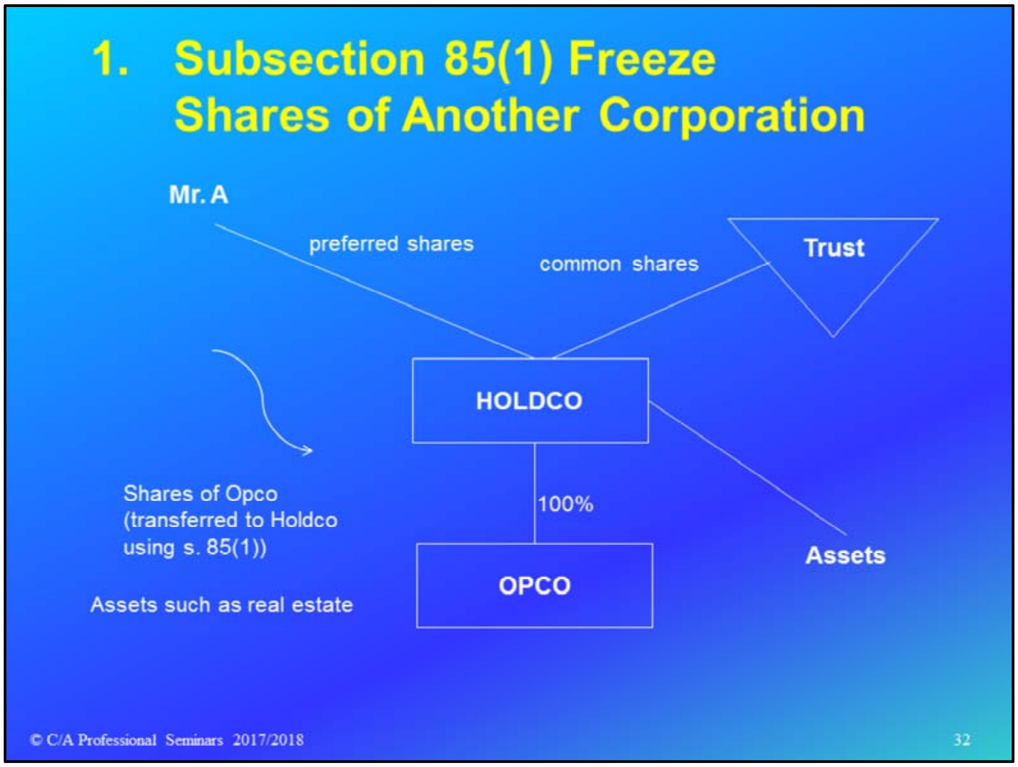
Techniques Utilized to Implement an Estate Freeze

7. Inverted subsection 85(1) freeze, roll down

8. Inter-corporate loan freeze

9. Stock dividend freeze



Subsection 85(1) can be used to freeze the value of shares of an operating company. This could be accomplished by transferring the common shares of an operating company to a holding company. The transferor would take back freeze shares in the holding company while the common shares would be issued to the intended beneficiaries of the freeze. Subsection 85(1) allows a taxpayer to elect to have the transfer take place at a value that is equal to the Opco share's adjusted cost base. This elected amount becomes the adjusted cost base of the Opco shares now owned by Holdco. As a result, the capital gain is deferred until Holdco disposes of the Opco shares. In general, the transferor will be able to take back non-share consideration up to the paid-up capital of the Opco shares transferred (due to s. 84.1). Shares will be issued for the remaining consideration (i.e., fair market value minus PUC) if the transaction is to take place without any immediate tax costs. Must watch out for s. 84.1.

If the taxpayer decides to completely freeze the future growth of the assets in the corporation, he will take back preferred shares with a fixed redemption value that are retractable. Common shares could then be issued to the individual's spouse, children or a trust for their benefit. The common shares would be issued for nominal consideration.

It is important that when a spouse or a trust subscribes for common shares, the funds are not received from the transferor. Otherwise, the attribution rules could apply to attribute dividends received on those shares to the transferor. In addition, any capital gains realized by the spouse on the common shares would be attributed back to the transferor.

The essence of the income splitting structure is that only a nominal amount (say $1) is needed for the common share subscription. [This will change in 2018 if the July 18, 2017 proposals are enacted.]

Attributes of Freeze Shares

Canada Revenue Agency's Requirements

1. Preference and priority on liquidation etc.
2. Retractable
3. Reasonable dividend entitlement
4. Fair market value equal to assets transferred or shares being frozen
5. Voting rights on matters involving a change to their attributes

If the transferor takes back a class of frozen shares, they will typically have the following attributes:

- Preference and priority on liquidation and dividends
- Retractable (at option of holder)
- Redeemable (at option of corporation)
- Reasonable dividend entitlement
- Fair market value equal to the fair market value of the assets transferred.

These shares could be voting or non-voting depending on the objectives of the transferor.

Attributes of Freeze Shares

Canada Revenue Agency's Requirements

Also

1. Shares may not have to be retractable if dividend entitlement is cumulative. However, this may defeat objective of some freezes
2. May not require any dividend entitlement if retractable
3. Corporation should undertake not to pay dividends on other shares if they result in insufficient net assets to redeem freeze shares

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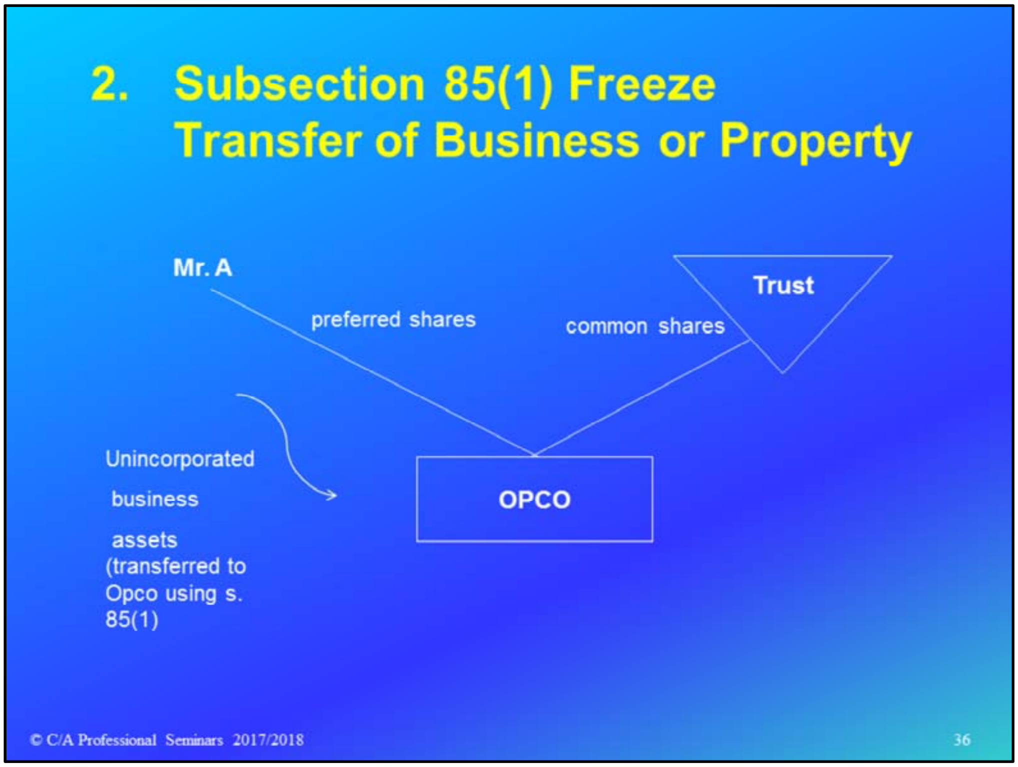
Subsection 85(1) Freeze
Transfer of Business or Property

Advantages	Disadvantages
• Can implement full or partial freeze	• Double taxation possibility
• Creditor proofing	• HST issues
• Income splitting	• Land transfer tax if real estate
• Multiply capital gains exemption	• Section 74.4
	• Section 84.1



Where a person owns assets which have unrealized gains, these assets can be transferred into a corporation without realizing those gains. Subsection 85(1) allows a taxpayer to elect to have the transfer take place at a value that is equal to the transferred properties' adjusted cost base. This elected amount becomes the adjusted cost base of the assets received by the corporation, and as a result, the capital gain is deferred until the corporation disposes of the assets.

In general, the transferor will be able to take back non-share consideration up to the cost of the assets transferred to the corporation. Shares will be issued for the remaining consideration (i.e., fair market value minus ACB) if the transaction is to take place without any immediate tax costs.

The same principles discussed in previous slides apply to this type of freeze as well.

Subsection 85(1) Freeze
Shares of Another Corporation

Advantages

- Creditor proofing of Opco
- Income splitting
- Can implement full or partial freeze
- Can crystallize capital gains exemption

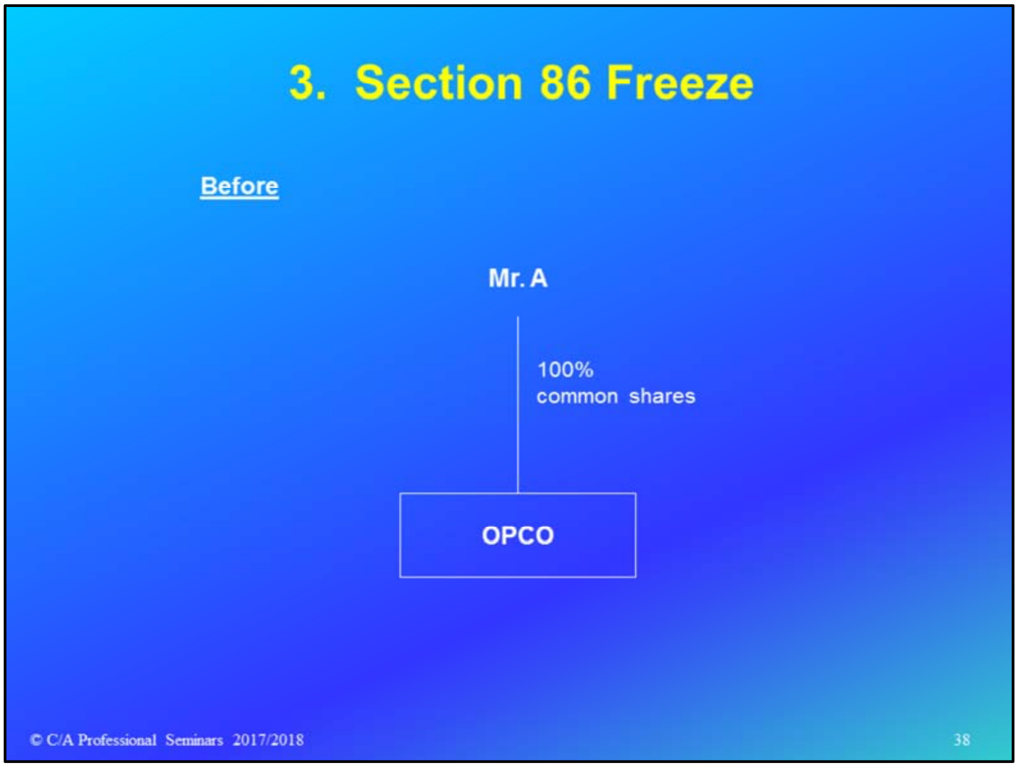
Disadvantages

- Additional corporation
- Double taxation possible
- Holdco not entitled to capital gains exemption
- Application of Sections 74.4 and 84.1

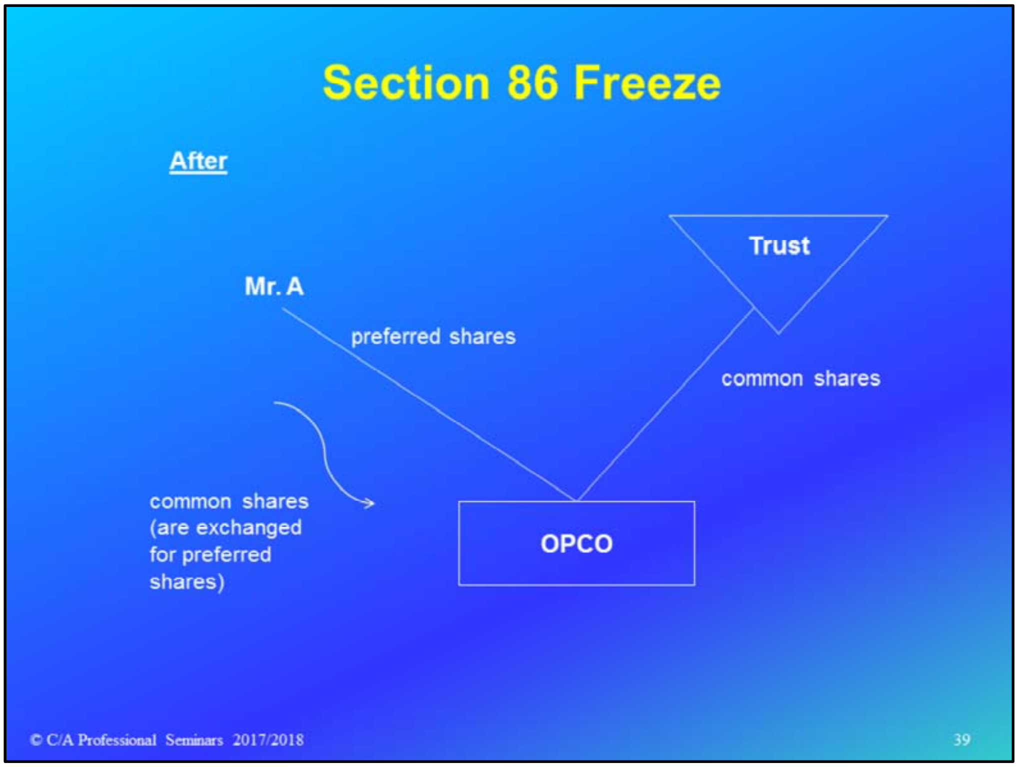
Section 74.4 is an anti-avoidance rule that could apply to deem income to the freezor, where certain conditions are met. Section 74.4 was discussed in module 4.

Section 84.1 applies on a non-arm's length sale of shares. It applies where a person sells shares of a corporation to a non-arm's length person who purchases them through a holding company.

Where 84.1 applies, the vendor is deemed to have received his proceeds as a dividend and not as a capital gain.



An estate freeze of an existing operating company using the provisions of subsection 85(1) will usually involve the incorporation on a new holding company. An estate freeze can also be implemented by way of a section 86 share reorganization, which does not require a holding company.



Under a section 86 share reorganization, the freezor will exchange all of his common shares for preferred shares. The intended new shareholder of the estate freeze will subscribe for the common shares. The preferred shares received in exchange for common shares should have the same attributes as the preferred shares issued pursuant to a subsection 85(1) freeze, and should be subject to a price adjustment clause. However, unlike the subsection 85(1) freeze, there is no need to file a tax election.

In order for a share reorganization to qualify for a rollover provided under section 86, the following conditions must be met:

a) The shares that are exchanged must be capital property;

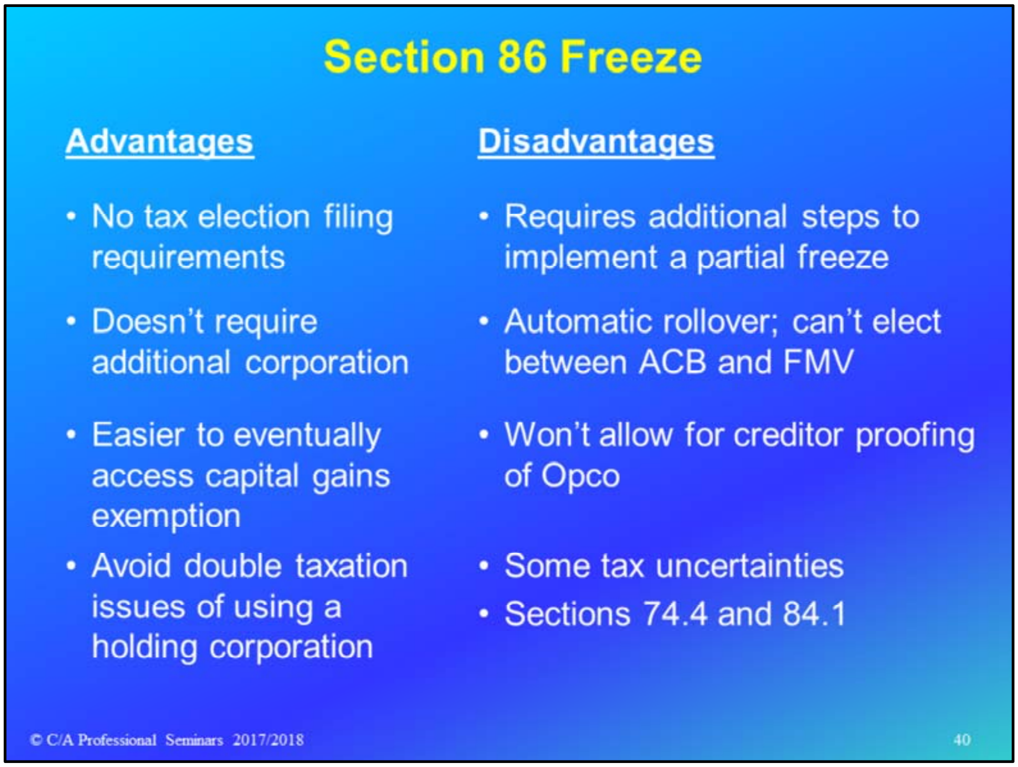
b) The freezor must dispose of all of his shares;

c) The freezor must receive at least one new share for the exchanged shares;

d) The transactions must occur in the course of a reorganization of the corporation's share capital; and

e) An election pursuant to the provisions of subsection 85(1) cannot be filed.

As an election cannot be filed under a section 86 share reorganization, the shares are automatically disposed of for proceeds equal to their adjusted cost base. Therefore, it is not possible to crystallize one's capital gains exemption on this type of reorganization.


Section 86 Freeze
Advantages
• No tax election filing requirements
• Doesn't require additional corporation
• Easier to eventually access capital gains exemption
• Avoid double taxation issues of using a holding corporation
Disadvantages
• Requires additional steps to implement a partial freeze
• Automatic rollover; can't elect between ACB and FMV
• Won't allow for creditor proofing of Opco
• Some tax uncertainties
• Sections 74.4 and 84.1
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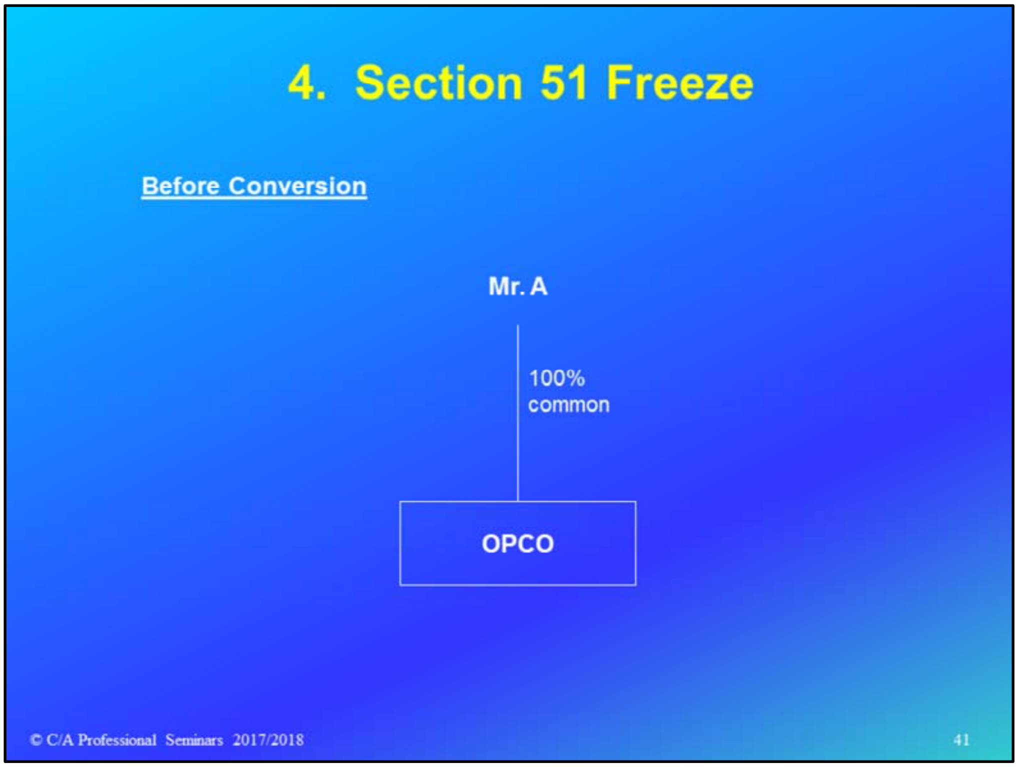
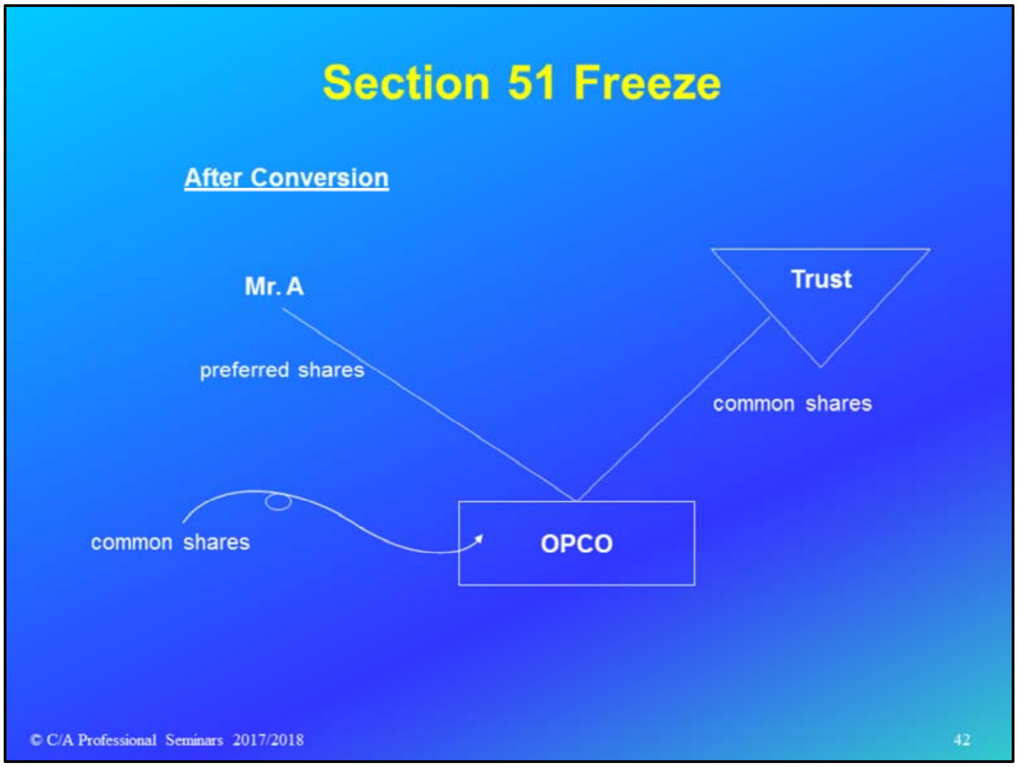


A section 51 (convertible property) freeze is similar to a section 86 share reorganization, with the distinction that under section 51, the shares are deemed not to be disposed of, when they are converted.



Unlike a section 86 share reorganization, a section 51 freeze allows for a partial freeze transaction, as not all of the shares would need to be exchanged.

No election is required for a rollover.

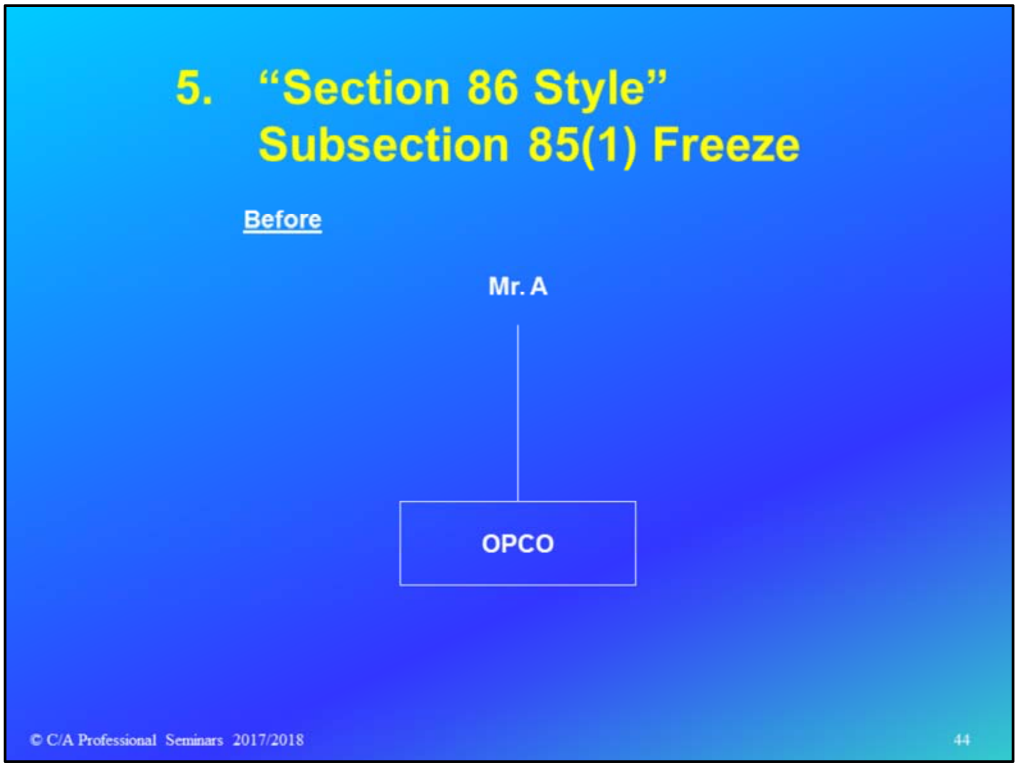
Section 51 Freeze

Advantages

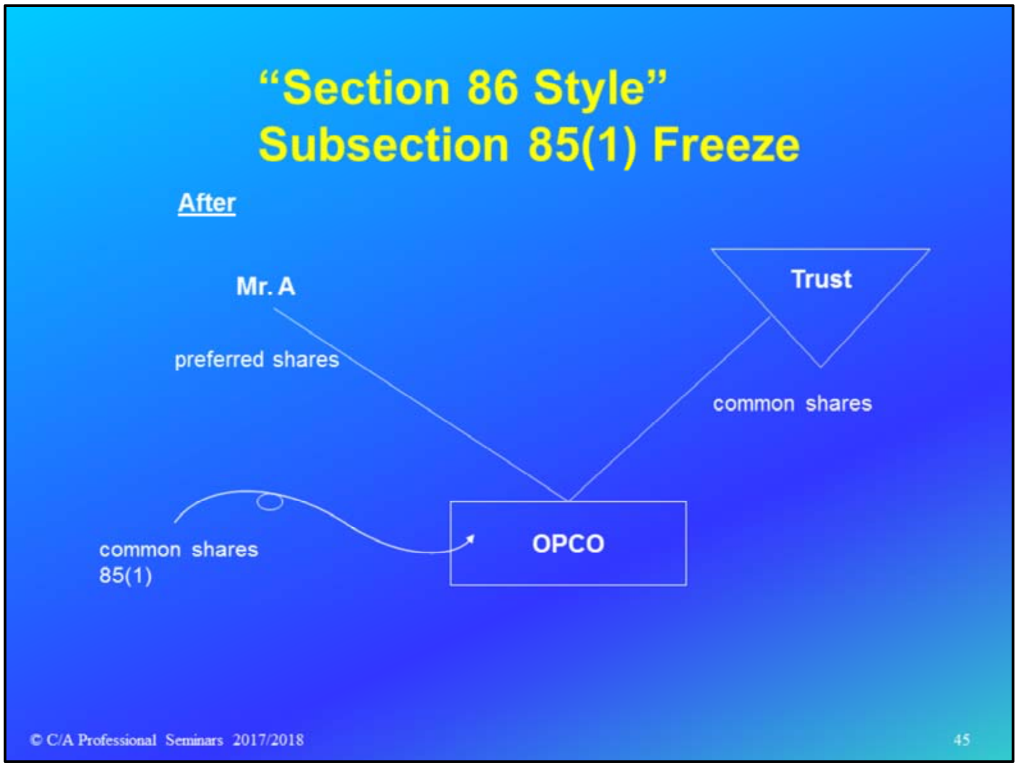
- Same as Section 86
- Can implement partial freeze
- Less technical uncertainty than section 86

Disadvantages

- Same as Section 86
- Cannot receive non-share consideration



As previously mentioned, a section 86 share reorganization does not allow for the freezor to crystallize his/her capital gains exemption on the initial share exchange. A "section 86 style" subsection 85(1) freeze overcomes this disadvantage.



Under a "section 86 style" subsection 85(1) freeze, the freezor will exchange all of his/her common shares of Opco for frozen preferred shares. However, on the share exchange, the freezor will file a subsection 85(1) election.

On filing the subsection 85(1) election, the freezor could elect an amount so as to crystallize his/her capital gains exemption. This technique allows the freezor to crystallize his capital gains exemption without incurring the cost of incorporating a new holding company. In addition, the new common shareholders now have access to the capital gains exemption as they will be holding the shares of Opco directly rather than indirectly through a holding company.

"Section 86 Style" Subsection 85(1) Freeze

Advantages

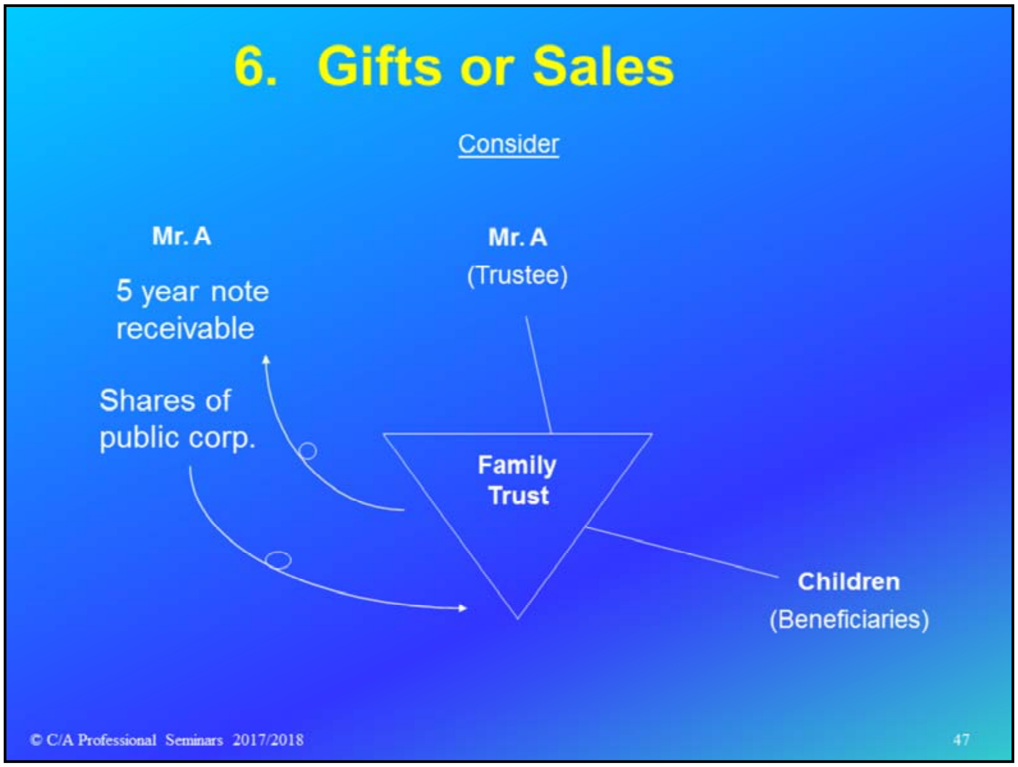
- Same as Section 86
- Can crystallize capital gain for gains exemption
- Can implement a partial freeze
- Less technical risk than section 86

Disadvantages

- Same as Section 86
- Must file T2057

A "section 86 style" reorganization should only be implemented where the freezor deals non-arm's length with the corporation. In situations where the freezor is at arm's length with the corporation, the stated capital which must be credited to the freeze shares under most corporate statutes must be equal to the fair market value of those shares. Pursuant to subsection 84(3) of the Act, the corporation will be deemed to have paid a dividend to the freezor to the extent that the paid up capital of the freeze shares exceed those of the common shares. This problem is avoided if the freezor is non-arm's length with the corporation being frozen since most corporate statutes will allow the corporation to credit the stated capital of its freeze shares with an amount equal to the stated capital of the shares exchanged.

This problem is also avoided when the freezor transfers the shares of a corporation to another corporation since either subsection 84.1(1) or 85(2.1) will usually apply to reduce the paid up capital of the shares received, thereby avoiding any deemed dividend.



An estate freeze can be affected by way of sale or gift of the growth assets to children. The main problems with a gift or sale of assets to children are:

a) immediate taxation; and

b) loss of control of the growth assets.

These problems can be mitigated, as illustrated by the example noted on this slide.

Assume, for example, that Mr. A owns shares of a public company which he believes will increase in value over the next few years. Mr. A would like his children to participate in the growth of these shares. If he were to give these shares directly to his children, he would immediately realize a capital gain to the extent that the current fair value of the gifted shares exceeds their adjusted cost base. Furthermore, he would lose control over the assets.

Mr. A could instead consider selling his shares to a trust for the benefit of his children. He would realize a capital gain on this transaction. However, he will have the ability to defer the gain over a five-year period if, as consideration for the sale, he receives a note with capital repayments due in five equal annual instalments. Under these circumstances, Mr. A would report only 20% of the total gain in each of the following five years.

If Mr. A is a trustee of the trust, he will be able to retain some control of the public company shares. However, if Mr. A is the sole trustee, then the provisions of subsection 75(2) (i.e., the reversionary rules) could apply. Thus, Mr. A should be one of three trustees to avoid the application of 75(2).

When the public company shares are ultimately sold by the trust, the capital gain realized on the sale of the shares could be allocated to the children, presumably who will be in a lower tax bracket.

A 10-year reserve is allowed when SBC shares or qualified farming or fishing property is sold to a child for a note.

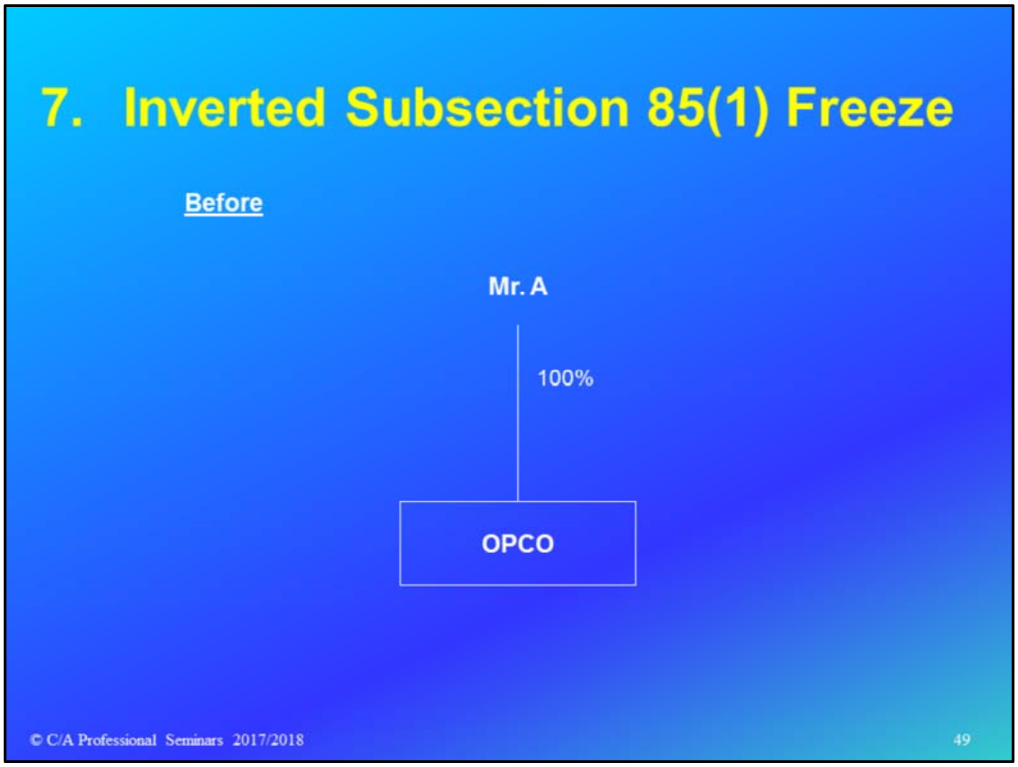
Gifts or Sales

Advantages

- No double taxation issues
- Future income splitting
- 10-year reserve for SBC shares, farming or fishing property
- Simple

Disadvantages

- Tax is created


7. Inverted Subsection 85(1) Freeze
Before
Mr. A
100%
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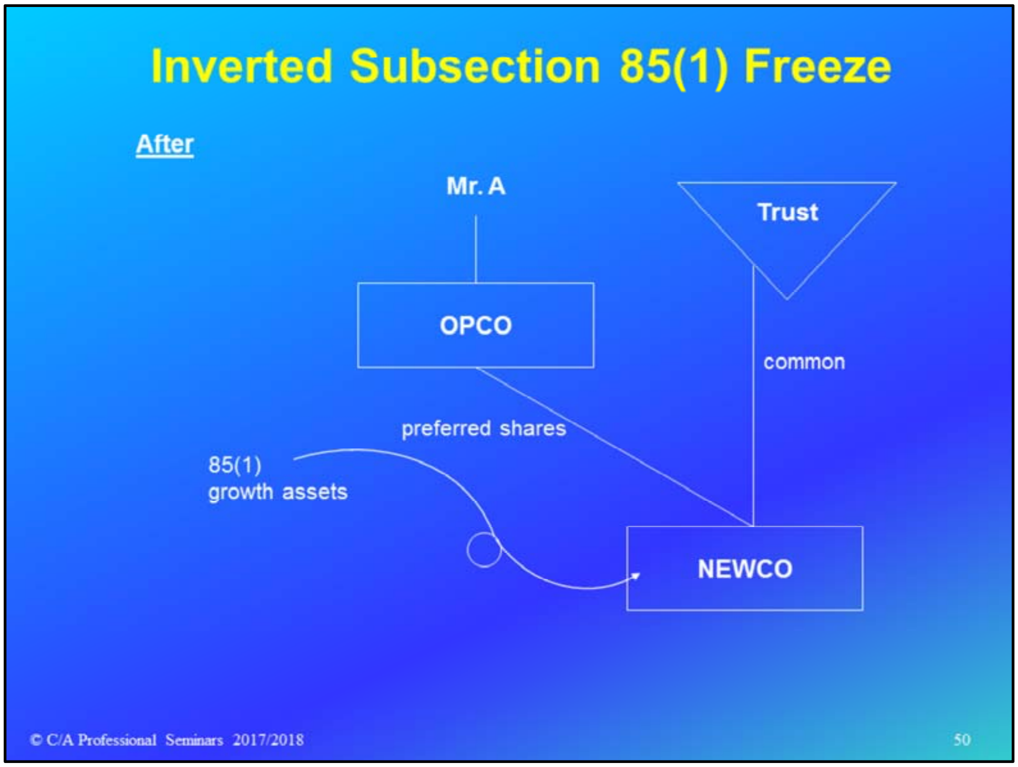


An inverted subsection 85(1) freeze can be implemented by having the frozen corporation transfer all or some of its assets to a new corporation in a tax-free transaction pursuant to subsection 85(1). The frozen corporation would receive preferred shares of the new corporation as consideration for the transfer equal to the fair market value of the assets transferred. The new corporation would then issue common shares to the new intended beneficiaries of the freeze for nominal consideration.

Inverted Subsection 85(1) Freeze

Advantages

- May avoid Section 74.4
- Can select specific asset to freeze
- Newco shares could qualify for capital gains exemption if Opco shares do not
- Income splitting

Disadvantages

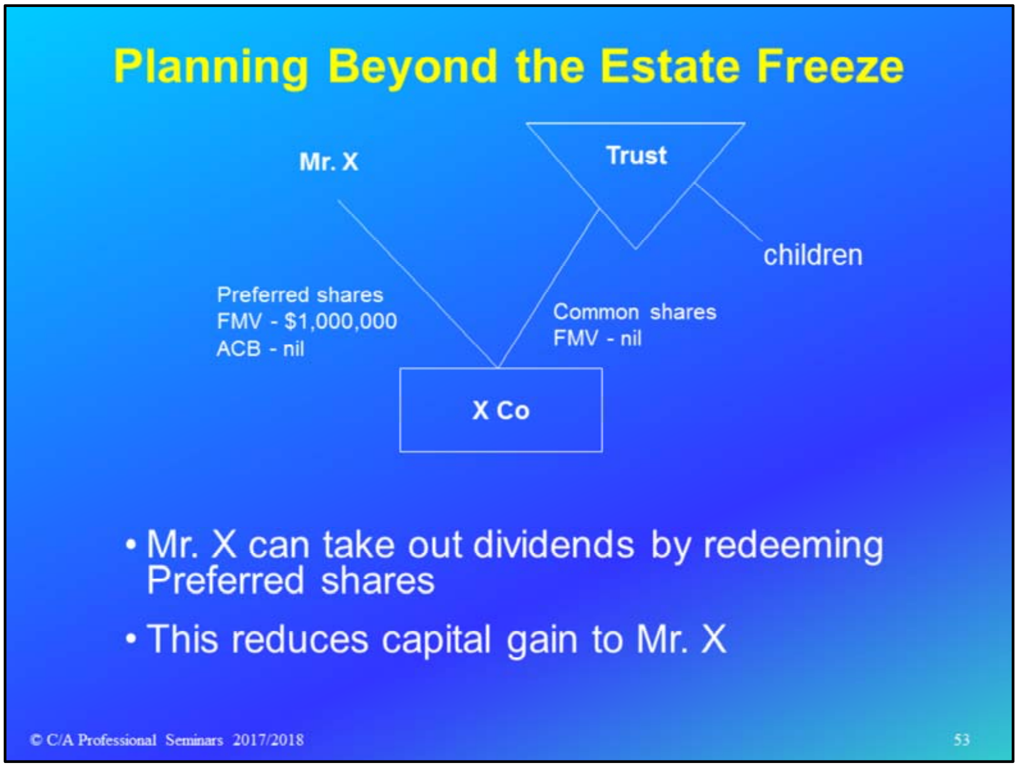
- Requires T2057 filing
- HST issues
- Valuation of specific assets required
- More complicated to implement asset transfer than share transfer

Estate Freezing

Unintended results:

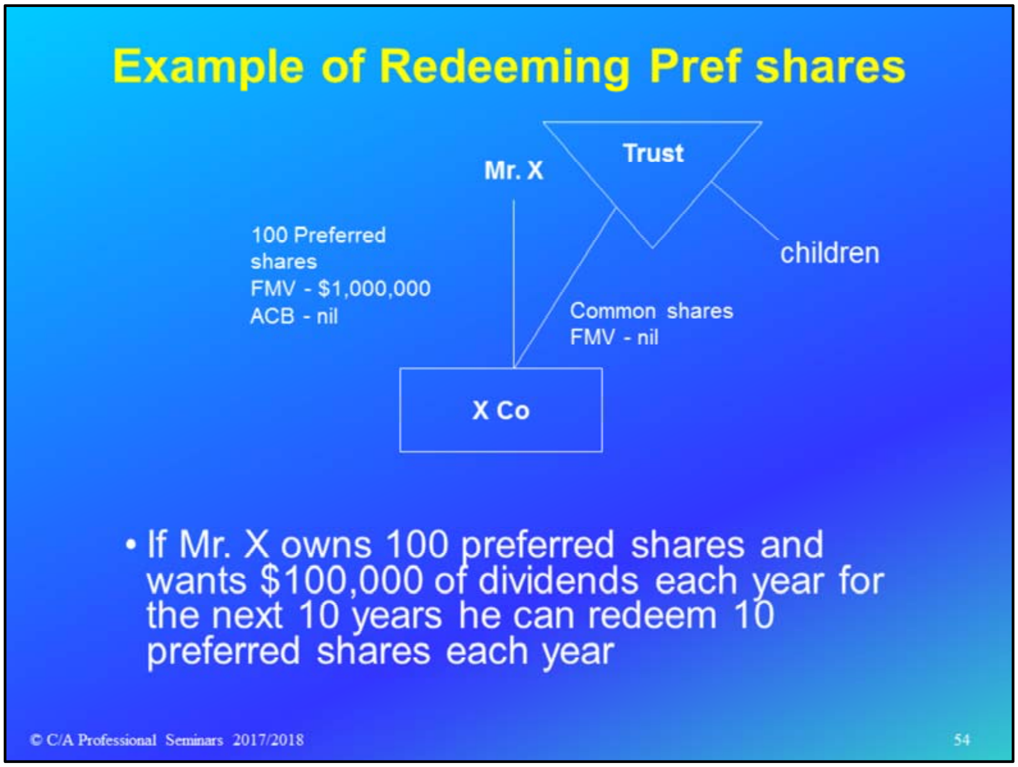
- Association – may result in corporations being associated
- Application of 74.4 – may cause this rule to apply if spouse or minor children are shareholder or trust beneficiaries

Note how broadly the association rules apply where a discretionary family trust is used that owns over 50% of voting or non-voting common shares.



Planning strategies beyond the estate freeze can reduce tax payable on death.

Mr. X can take his remuneration by dividends. Such dividends can be from redemption of preferred shares. This reduces his capital gain as the shares are redeemed.



Assume Mr. X has done an estate freeze and Mr. X owns 100 preferred shares worth $1M with an ACB and PUC of nil. If Mr. X wants to receive $100,000 of dividends each year for the next ten years then: each year, Mr. X can have X Co. redeem 10 preferred shares. This redemption of shares will trigger a $100,000 deemed dividend each year and will reduce the value of Mr. X's assets (since he owns less shares).

At the end of 10 years, Mr. X will no longer own any preferred shares and the value of his estate has been reduced to $0. This reduces his eventual capital gain on death.

Planning Beyond the Estate Freeze

Conclusions

- Estate freeze limits capital gain to that on hand at time of freeze, but does not then reduce the capital gains tax
- It is possible to reduce capital gains tax by redeeming shares over time with little or no incremental cost
- The process of share redemptions takes time

Problem Areas

Valuation
- Value must be appropriate, not unreasonable
- Professional valuation
- Price adjustment clause

Control
- Voting class of shares
- Separate from freeze shares
- Splits control and ownership

Redemption
- Often ignored
- Wasted opportunity

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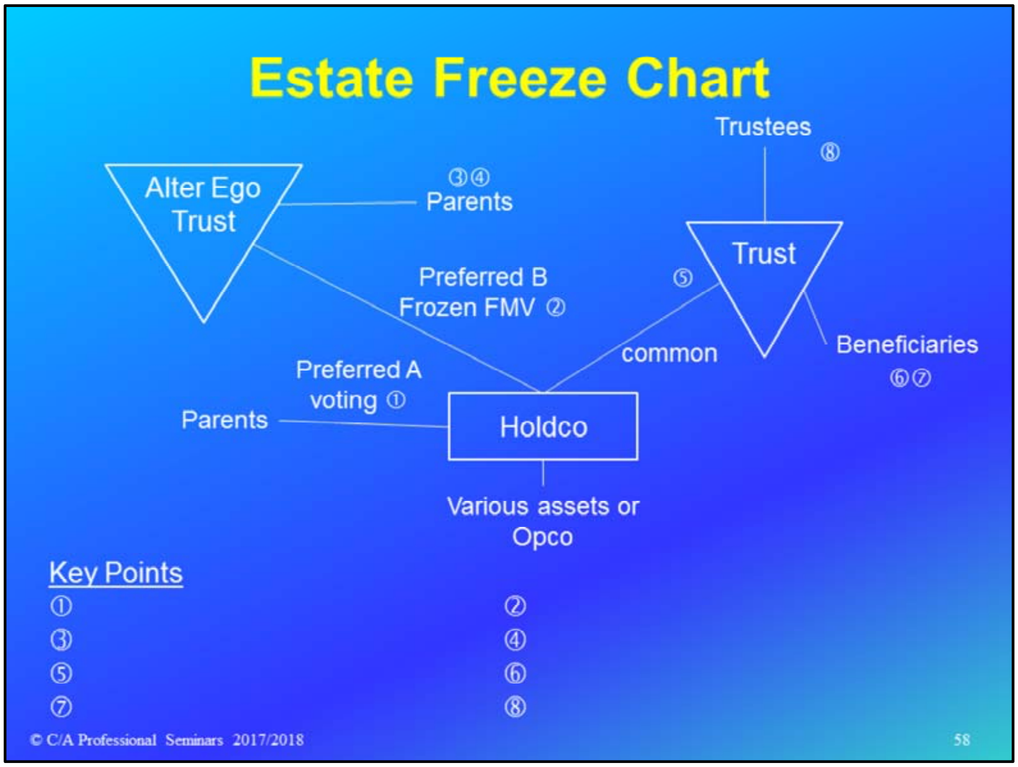
Problem Areas – Cont'd

Reversible freeze

- Parent is beneficiary of trust
- Protection against running out of funds later in life
- 21 years to make decision

Alter Ego trust etc.

- Trusts to hold preferred shares gives more time for share redemption program and post-mortem planning
- Use spousal, alter ego, joint partner trust
- Beware section 74.4 issues


Estate Freeze Chart
Trustees
⑧
Alter Ego Trust
③④
Parents
Trust
Preferred B
Frozen FMV ②
⑤
common
Beneficiaries
⑥⑦
Preferred A
voting ①
Parents
Holdco
Various assets or Opco
Key Points
①
②
③
④
⑤
⑥
⑦
⑧
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