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THE ESTATE FREEZE: POST-2017

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The estate freeze has been the cornerstone of estate planning for business owners for as long as capital gains taxation has been in existence in Canada, dating back to 1972. The main driver for its implementation has been income tax minimization at death to the business owner's estate, in regards to the corporate shares which he/she owned at that time. The purpose of this paper is to provide an overview of the implementation of an estate freeze and its significant considerations, and to provide an update on how the recent amendments to the statutory provisions of the Income Tax Act[ii] will impact upon estate freezes going forward.

What is an Estate freeze?

Simply put, an estate freeze is a corporate reorganization which is implemented to halt the future growth in value of the shares currently held by a particular shareholder[iii], thereby permitting that future growth in the value of the company[iv] to accrue to another class of shareholders. Typically, that class of shareholders will be the family and/or issue of the Freezor.

Why Implement an Estate freeze?

When a Canadian resident individual passes away, the individual is deemed to dispose of his capital property for its fair market value immediately before his/her death[v]. Any inherent capital gains or losses of the property(ies) owned at that time will be included in the taxable income in the decedent's final personal income tax return for year of death[vi].

The foregoing deemed disposition of the decedent's capital property can be deferred in a particular instance[vii]. Specifically, where the capital property is transferred or distributed to:

i) the decedent's spouse or common-law partner, who was a Canadian resident immediately before the decedent's death; or
ii) a testamentary spousal trust[viii], that was a Canadian resident immediately after the time that the property vested indefeasibly in the trust; and

the property has vested indefeasibly with such person within the period ending 36 months after the death of the decedent, then the capital property will be deemed to have been disposed of at its adjusted cost base ("ACB"), or in the case of depreciable property, at the lesser of its capital cost and cost amount, to the decedent immediately before his/her death.

While the foregoing tax deferral rule is certainly beneficial to avoid paying capital gains taxes upon the death of a business owner who has a surviving spouse, eventually the tax liability will be borne by that surviving spouse and could very well grow to a much higher amount than upon the earlier death of the business owner. A numerical example best illustrates this concept.

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Assume a spouse (“Spouse A”) is the sole shareholder of Opco. It is estimated that these shares have a current fair market value (“FMV”) of $5 million and has a nominal adjusted cost base (“ACB”). The spouse is married (“Spouse B”) and has adult children. It is projected that on a balance of probabilities, Spouse A will pass away before Spouse B, and that Spouse B will pass way before the adult children. Let’s assume for the purposes of this example, that the shares of Opco will have grown in value to $12 million when Spouse A passes away, and to $16 million when Spouse B passes away.

If Spouse A structures his last Will and testament to provide that the Opco shares will vest indefeasibly with Spouse B upon his death, either directly or through a testamentary spousal trust, then there will be no deemed disposition of the Opco shares at the time of Spouse A’s death. That said, when Spouse B passes away, the difference between the FMV of the Opco shares at that time (i.e. $16 million) and the ACB of the Opco shares (nominal) will be recognized as a capital gain, which will be included as part of the taxable income within Spouse B’s final personal income tax return.

Consequently, while it was clearly beneficial to defer paying income taxes in respect of the Opco shares upon Spouse A’s death, the negative income tax consequence which arose is that the capital gain which was realized when Spouse B passed away increased from $12 million to $16 million, since the Opco shares continued to grow in value following Spouse A’s death.

In the context of this example, it cannot be ignored that the capital gains tax implication to Spouse A’s estate could have been limited to when the shares had $5 million of value, if some form of proactive course of action was implemented then, as opposed to having done nothing and allowing the shares to grow to $12 million, or alternatively, to $16 million in value. The foregoing proactive course of action is commonly referred to as an estate freeze.

How is an Estate Freeze Implemented?

Most estate freezes rely on one of two tax-deferred corporate reorganization provisions of the Income Tax Act, namely:

i) The Freezor transfers his/her common shares of Freezeco (the “Freeze Shares”) to another corporation (“Holdco”). As consideration for his Freeze Shares, the Freezor will receive a class of preferred shares from Holdco, which are redeemable and retractable for an amount equal to the value of the Freeze Shares transferred to Holdco at that time. The purchase and sale agreement will provide that the parties to the transfer will jointly elect to file a tax election form with the Canada Revenue Agency (the “CRA”) in accordance with subsection 85(1), whereby the parties will agree that the elected transfer price for the transfer will be equal to the Freezor’s ACB of his/her Freeze Shares; or

ii) The Freezor exchanges all of his/her Freeze Shares for a class of preferred shares of Freezeco. Similar to the share transfer in i) above, the preferred shares will be redeemable and retractable for an amount equal to the value of the Freeze

Shares transferred to Freezeco at that time. The foregoing share exchange will occur on a tax-deferred rollover basis, in accordance with subsection 86(1). One advantage that this latter form of corporate reorganization has in comparison to i) above is that a tax election form need not be filed with the CRA.

Diagrams of these two types of corporate reorganizations have been depicted in Appendix A to this paper. Either of these types of reorganizations may also provide the Freezor with the opportunity to crystallize his/her lifetime capital gains exemption ("LCGE"), if the shares being disposed of are regarded as Qualified Small Business Corporation ("QSBC") shares.

Besides the necessity for the preferred shares to be redeemable and retractable for the fair market value of the consideration received for the issuance of the Freeze Shares, there are some other typical clauses which are advisable to be included in the attributes of the preferred shares being received by the Freezor. These attributes are based on comments made by the CRA which date back to their Round Table at the 1980 Canadian Tax Foundation Annual Tax Conference, and which have since been affirmed at the 1993 Canadian Tax Foundation Annual Tax Conference and more recently, at the Round Table on Federal Taxation at the 2008 APFF conference:

i) The shares must be entitled to receive dividends, not in excess of a reasonable amount.
ii) The shares must have voting rights in respect of any reorganization of capital which would affect the attributes of the shares or their value.
iii) The shares must have preference as to return of capital on liquidation, dissolution or winding up.
iv) There must be no restriction on transferability, other than the normal private corporation restrictions.
v) The corporation must undertake not to pay dividends or do share redemptions on other classes of shares, where the payment of dividends or redemptions would reduce the assets below an amount sufficient to permit full value redemption.
vi) The attributes should contain a price adjustment clause ("PAC") for the redemption price of the preferred shares, which is applicable when the redemption price agreed to by the parties is not equal to the FMV of the common shares exchanged.

As noted, it is not necessary for the preferred shares to be voting shares (except, as noted, on corporate reorganization issues which would affect its attributes or its value), nor must the preferred shares provide for cumulative dividends.

What are the Significant Income Tax Considerations to the Freezor?

There are two significant tax considerations when implementing an estate freeze which affects the Freezor:

i) The related party benefit conferral rule[ix]; and
ii) The corporate attribution rule[x].

The Related Party Benefit Conferral Rule (the "RPBC")

The relevant RPBC statutory provision to be examined will depend upon the manner in which the estate freeze in undertaken. For example, if the estate freeze entails undertaking a transfer to which the statutory rules of section 85 apply, then the relevant RPBC statutory provision would be paragraph 85(1)(e.2). On the other hand, if the estate freeze is undertaken in a manner in which the statutory rules of section 86 apply, then the relevant RPBC statutory provision would be subsection 86(2). Other such RPBC rules may be found in subsection 51(2) and paragraphs 87(4)(c) - (e).

The premise of the RPBC rule is whether the FMV of the Freeze Shares (before the transaction) exceeds the aggregate of the FMV of the consideration received by the Freezor following the reorganization (the "Excess Amount"), and it is reasonable to regard any part of that Excess Amount to be a benefit that the Freezor wished to confer on a person related[xi] to the Freezor. In such an event:

i) In the case of paragraph 85(1)(e.2), the elected amount will be increased by the Excess Amount, regardless of what was agreed to by the Freezor and the transferee corporation when they filed their T2057 tax election form.
ii) In the case of subsection 86(2), the Freezor will be deemed have disposed of his/her Freeze Shares for proceeds of disposition equal to the lesser of: i) The FMV of the Freeze Shares immediately before its disposition; and ii) the sum of the cost to the Freezor of the consideration received for the Freeze Shares, as determined by paragraph 86(1)(a), and the Excess Amount.
iii) In the case of subsection 51(2), the Freezor will be deemed have disposed of his/her Freeze Shares for proceeds of disposition equal to the lesser of: i) The FMV of the Freeze Shares immediately before the exchange; and ii) the sum of the ACB to the Freezor of the Freeze Shares immediately before the exchange and the Excess Amount.
iv) In the case of paragraph 87(4)(c), the Freezor will be deemed have disposed of his/her Freeze Shares for proceeds of disposition equal to the lesser of: i) The FMV of the Freeze Shares immediately before the amalgamation; and ii) the sum of the ACB to the Freezor of the Freeze Shares immediately before the amalgamation and the Excess Amount.

To illustrate this concept, assume that Mr. A is the sole owner of the shares of Opco, having an FMV of $10 million and an ACB of $1,000. He decides to undertake an estate freeze at that time, pursuant to subsection 86(1), whereby all of his common shares are exchanged for a class of preferred shares, whose redemption and retraction value amounts to $6 million. As part of the estate freeze, Mr. A's adult children subscribe for new common shares of Opco for nominal consideration. Assuming it is reasonable to consider that the $4 million shortfall in the FMV of the Opco preferred shares received in relation to the FMV of the Opco common shares was a benefit which Mr. A wished to confer on his adult children, Mr. A will be deemed to have disposed of his Opco shares for proceeds of disposition of $4,001,000[xii], thus resulting in a capital gain of $4 million to be realized at the time of the estate freeze.

The Tax Court of Canada ("TCC") recently released an interesting decision dealing with the application of the RPBC rule contained in subsection 86(2), in the case of Dr. David Mady v Her Majesty the Queen[xiii]. The facts of this particular case are as follows:

i) Dr Mady owned a professional corporation named Mady Dentistry Professional Corporation ("MDPC").
ii) On December 15, 2011, Dr Mady entered into a share purchase agreement to sell the shares of MDPC for $4.5 million.
iii) The facts bear out that it was intended an estate freeze be conducted as of July 1, 2011. That said, it was not undertaken until January 13, 2012, the same day that the MDPC shares were sold to the purchasers of such shares. The valuation set for the estate freeze was determined retroactive to July 1, 2011.
iv) The valuator determined that the value of MDPC for the estate freeze amounted to $2,071,500, notwithstanding that the shares were sold that same day for $4.5 million.
v) To effect the estate freeze, Dr Mady froze his common shares of MDPC for a class of preferred shares worth $2,071,497, and 100 class B common shares, 100 class C common shares, and 100 class D common shares, each class having a value of $1.
vi) Dr Mady proceeded to sell 85 class B common shares to his wife, 85 class C common shares to his daughter, and 85 class D common shares to his other daughter, for 85 cents each.
vii) The share sale arose later that day. Dr Mady's wife and two daughters each realized proceeds of sale of $734,888 and consequently, taxable capital gains of $367,443. Each one claimed their available LCGE, to shelter their taxable capital gains from income tax.
viii) The Minister of National Revenue (the "Minister") reassessed Dr Mady's 2012 taxation year, to increase his taxable income by $1,214,252 of taxable capital gains. The basis for the Minister's reassessment was the following:

    a) The Minister's primary argument was that subsection 86(2) applied to the transaction; and
    b) The Minister's secondary argument was that subparagraph 69(1)(b)(i) applied to the sale, since it was a non-arm's length sale which was transacted at less than fair market value.

Justice Hogan rejected the subsection 86(2) argument raised by the Minister. Justice Hogan's rationale was that Dr. Mady was both the sole shareholder of MDPC both before and immediately after the corporate reorganization was completed. For subsection 86(2) to have applied, Dr. Mady's wife and daughters would have had to have been shareholders of MDPC prior to the share reorganization, or have become shareholders of MDPC as a result of the share reorganization. Because they weren't, there could not possibly have been a value shift from Dr Mady to another related person for subsection 86(2) to have become operative at that time.

Despite this positive ruling in favor of Dr. Mady, Justice Hogan held that subparagraph 69(1)(b)(i) did apply to the share sale between himself and his wife and daughters. Not surprisingly, Justice Hogan quashed the valuation prepared for Dr Mady, which purported that the shares had a value of only $2,071,500, when they were sold that very same day to an arm's-length purchaser for $4.5 million. Accordingly, Justice Hogan held that it was clear that Dr Mady had undersold the 85 class B, 85 class C, and 85 class D common shares to his wife and daughters. For the foregoing reason, it was appropriate for the Minister to have included the taxable capital gains of $1,214,252 in his 2012 taxable income[xiv]. Fortunately for Dr. Mady, Justice Hogan reversed the gross negligence penalties which was also levied by the Minster when it had issued the notice of reassessment against him.

In order to combat a successful argument by the Minister that the RPBC rules apply to an estate freeze, it is important to insert a PAC either directly into the attributes of the freeze shares to be issued[xv], or alternatively, as part of the share purchase and sale or share exchange agreement, as the case may be. The CRA's administrative positions on the use of PACs is summarized in Income Tax Folio S4-F3-C1. It is advisable that taxpayers and their advisers comply with these administrative positions, in order to ensure that the CRA will honor the PAC should a future dispute arise with regards to the valuation of the Freeze Shares. A typical PAC will not only contain an adjustment to the redemption and retraction value of the remaining preferred shares on hand, once the valuation dispute with the relevant taxation authority is settled, but will also require that a payment be made by the relevant party for any excess or shortfall in proceeds due to a redemption or retraction of such shares in the past.

<u>The Corporate Attribution Rule</u>

The corporate attribution rule is contained in section 74.4. Despite the fact that the imposition of an assessment under section 74.4 could result in double taxation, many practitioners are unaware of this set of rules, and even more surprisingly, so are CRA auditors.

The corporate attribution rule applies when the following conditions are satisfied:

i) An individual has transferred or lent property to a corporation, either directly or indirectly, by means of a trust or by any means whatever.

ii) One of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of the individual, and to benefit a *designated person*[xvi] in respect of the individual, either directly or indirectly, by means of a trust or by any other means whatever.

Even if the foregoing parameters apply, the application of the corporate attribution rule must be determined annually by the individual. For the rule to apply to a particular taxation year of the individual following when the loan or transfer was made:

i) The individual must be a resident of Canada throughout that period;
ii) The corporation must not be a *small business corporation*[xvii] throughout that period; and
iii) The person must be a designated person of the individual throughout that period, and would have been a *specified shareholder*[xviii] of the corporation.

Assuming the corporate attribution rule applies to an individual for a particular taxation year, then the individual will be imputed interest income for the year, determined by the following equation:

Outstanding Amount[xix] of the transferred property or loan x the *Prescribed Rate of Interest*[xx] for such periods in the year

Less:

The sum of:

i) the actual amount of interest received by the individual in respect of the transferred or loaned property in the year :
ii) all taxable dividends[xxi] received by the individual in the year on shares that were received from the corporation as consideration for the transfer or as repayment for the loan, and the shares were either *excluded consideration* [xxii] at the time the dividends were received or are shares substituted therefor that were excluded consideration at that time; and
iii) where the designated person is a *specified individual*[xxiii] in relation to the year, the taxable dividends received by the designated person that can reasonably be considered to be part of the benefit sought to be conferred and is subject to the Tax on Split Income[xxiv] ("TOSI") rules.

The corporate attribution rule is particularly punitive, because the corporation will be taxable in respect of the income arising from the transferred or loaned property, while at the same time, the individual is imputed interest income from the outstanding amount of the transferred or loaned property to the corporation.

The reason that the corporate attribution rule is a concern in the context of an estate freeze, is because most estate freeze typically involves having the Freezor transfer his/her Freeze Shares to a corporation, whether it be to the same corporation such as an exchange to which section 86 applies, or to another corporation such as in a subsection 85(1) tax-deferred rollover. In view of the foregoing, where the estate freeze is being undertaken at a time to benefit designated persons in relation to the Freeezor, consideration should be given to structuring the estate freeze in a manner which will eliminate or mitigate the Freezor's exposure to the corporate attribution rule. Some options would include the following:

i) Pay dividends on the preferred shares issued as consideration for the Freeze Shares.
ii) Ensure the corporation is a small business corporation during the relevant period in the particular taxation year.
iii) Structuring the beneficial ownership of the new common shares by a designated person to comply with subsection 74.4(4).
iv) Structuring the estate freeze in a manner in which there won't be a disposition of the Freeze Shares by the Freezor.

Subsection 74.4(4) is a provision which exempts a transfer or loan of property from being subject to the corporate attribution rule. It will apply where the following conditions are satisfied:

i) The only interest that the designated person has in the corporation is by means of a beneficial interest in a trust;
ii) By the terms of the trust, the designated person may not receive or otherwise obtain the use of any of the income or capital of the trust, while being a designated person in respect of the individual. For example, there could be a clause in the trust that a child is not eligible to receive income or capital until he/she turns 18 years old; and
iii) The designated person has not received or otherwise the use of any of the income or capital of the trust, and no deduction has been made by the trust in computing its income under subsections 104(6) or (12), in respect of amounts paid or payable to, or included in the income of, that person while being a designated person in respect of the individual.

While inserting a subsection 74.4(4) type clause into the trust's indenture will prevent any risk of the corporate attribution rule applying to the Freezor, there is one significant negative aspect to this solution that cannot be overlooked. Specifically, if a future sale of the Freezeco shares arises, and assuming the company's shares are QSBC shares at that time, the presence of the subsection 74.4(4) clause will preclude the ability to sprinkle the capital gain realized by the trust amongst its beneficiaries who are designated persons (spouse and minor children) in respect of the Freezor, in order to make use of their LCGE at that time[xxv].

Perhaps structuring the estate freeze in a manner that avoids the corporate attribution rule altogether may be the best option in order to undertake an estate freeze, where designated persons in respect of the Freezor are involved. The following are some alternatives how this may be accomplished:

i) Often an operating company is owned by a holding company. In a typical estate freeze, the Freezor would be exchanging his/her Freeze Shares for preferred shares of the holding company. Instead, the estate freeze could be undertaken at the operating company level, whereby the holding company would exchange its Freeze Shares for preferred shares of the operating company. The family trust would buy shares directly in the operating company. The individual would continue to own the common shares of the holding company. By virtue of the foregoing, the corporate attribution rule would be avoided, because it would be the holding company, rather than the Freezor, which would be disposing of shares to a corporation[xxvi].

ii) Instead of the individual exchanging his/her Freeze Shares for a class of preferred shares, the corporation could instead pay a high/low stock dividend of preferred shares. The redemption/retraction value of the preferred shares would be established to be the FMV of the common shares at the time of the freeze, less a nominal amount. The stated capital of the issued preferred shares would be set at a nominal amount, so that the amount of the stock dividend subject to tax to the Freezor as dividend income would also be low[xxvii]. Thereafter, the Freezor would sell his common shares which are now of a nominal value to his/her issue or to the family trust which is to be formed for purposes of the estate freeze. Because the Freezor never disposed of his common shares to a corporation, the corporate attribution rules do not apply.

iii) A disposition does not occur where a share reorganization occurs in accordance with subsection 51(1)[xxviii]. For example, assume the Freezor owns 1,000 common shares of Freezeco. If only 999 of the 1,000 common shares are exchanged for a class of preferred shares, then subsection 51(1) would apply to the exchange and not subsection 86(1)[xxix]. Thereafter, the Freezor would sell his single common share to his/her issue[xxx]. Consequently, since the estate freeze is undertaken to conform with subsection 51(1), the corporate attribution rule would not apply to the Freezor in respect of his/her ownership of the preferred shares, since there had not been a disposition of the 999 common shares by the Freezor.

Another potential benefit of undertaking the estate freeze under the second and third alternatives described above is that if the common shares are sold by the issue/family trust even within two years of its acquisition from the Freezor, such shares could still satisfy the 24 month holding period test for purposes of being classified as QSBC shares, since such shares were formerly owned by a related person[xxxi].

Diagrams of these three types of corporate reorganizations have been depicted in Appendix B to this paper.

What are the significant considerations when undertaking an Estate freeze?

Ownership of the Freezeco common shares

Prior to undertaking the estate freeze, a decision has to be made as to the future ownership of the common shares of Freezeco. Essentially, the decision comes down to whether the shares shall be owned directly by the Freezor's issue, or whether beneficial ownership of such shares shall be held through a discretionary family trust.

In my opinion, ownership of the shares through a discretionary family trust is virtually always a better idea than direct ownership[xxxii]. Some tax and non-tax benefits of share ownership through a family trust, rather than direct ownership, are the following:

i) With direct ownership, the Freezor must make a decision immediately how the common shares are to be owned by each child. That is not the case with a discretionary family trust. For all intents and purposes, that decision can be deferred for up to 21 years[xxxiii]. Similarly, ownership through a family trust can allow for the future ownership of the common shares by the Freezor's future issue or issue of such issue. The foregoing is not possible with direct share ownership, since the shares must be issued to persons who are alive at that time. Therefore, a family trust provides a greater degree of flexibility as to Freezeco's common share ownership.

ii) Because the issue's interest in the family trust is discretionary, the FMV of the foregoing is typically worth considerably less than if the corporate shares were owned directly by the issue. Accordingly, the foregoing could afford a greater level of protection in dealing with the issue's spouse in the event of a future marital dissolution or dealing with the issue's creditors in the event of a future insolvency.

iii) With direct share ownership, there is no flexibility to sprinkle dividends among the shareholders in a proportion which is different than their direct shareholdings in the company. With a discretionary family trust, however, that is not the case i.e. it is possible for a family trust to pay its dividend income to one or more beneficiaries of the trust, at the discretion of the trustees. Therefore, a family trust provides a greater degree of flexibility when it comes to sprinkling dividend income among the Freezor's issue[xxxiv].

Assuming a family trust is to be established, some of the typical decisions which must be resolved are the following:

i) Who will be the settlor of the family trust, and what consideration will the settlor provide in order to settle the trust? The settlor should have no involvement with the trust following its settlement, in order to ensure that subsection 75(2)[xxxv] does not apply to the trust's formation, which could potentially give rise to many adverse income tax consequences.

ii) Who will be the trustees of the trust? It is usually preferable for there to be an odd number of trustees, in order to ensure that deadlocks do not arise when the trustees have to make decisions affecting the trust. The settlor should likely appoint an alternate trustee(s) in the trust's indenture, in the event of the death or incapacity of a named trustee.

iii) Who will be the beneficiaries of the trust? Will the trust's indenture provide for any corporate beneficiaries? Will the Freezor, his/her spouse, or both be included as beneficiaries of the trust[xxxvi]?

iv) What will be the duration of the existence of the family trust? Should it exist only for 21 years, or should it continue beyond that point in time? If it is carried on beyond 21 years the issue of the 21 year deemed disposition will have to be dealt with.

v) Any other specific terms and conditions which should go into the trust's indenture. For example, if a child of the Freezor passes away during the existence of the trust, will the child's issue become beneficiaries of the trust in his/her stead on a per stirpes basis? Also, if property is to be distributed from the Trust, should the trust's property be directed to a separate trust for the beneficiary until that beneficiary reaches an acceptable age limit[xxxvii].

The Acquisition of the Freezeco common shares

The most common manner in which the Freezeco common shares are acquired is that, following the freeze, either the Freezor's issue subscribes for new common shares of Freezeco, or alternatively, if a family trust is being established, then the trust will subscribe for the new common shares from funds provided to it by the settlor.

That said, there are several other options in which the Freezeco common shares can be acquired. For example, if the Freezor favors direct ownership of the common shares by his children, and assuming that they are of the age of majority, the Freezor could instead subscribe for the new common shares for a nominal subscription price, and then gift the shares to his children. There would be no adverse income tax consequences to the Freezor by making the gift to his adult children, since the common shares have nominal value, and the income attribution rule is not a concern since the children are not designated persons because they are of the age of majority. The main benefit of arranging the acquisition of the new common shares in this manner is that if the deed of gift provides that the gifted property is to be considered excluded property for purposes of the Family Law Act of Ontario, and assuming the child is married at the time that the gift is received, then the gifted shares will not be subject to equalization should the child face a future marital dissolution.

On the other hand, if a family trust is to be established, a gift of the common shares would not be advisable, because it may cause subsection 75(2) to apply to the future income derived from the gifted shares, as well as precluding a future tax-free rollout of any of the trust's property to its beneficiaries[xxxviii]. Instead, a sale of the common shares by the Freezor to the family trust is preferable[xxxix]. As with the gifted shares, the Freezor would not face any adverse income tax consequences by virtue of the sale to the family trust, because the common shares have nominal value.

Voting control over Freezeco

Typically, while the Freezor is willing to permit the future growth in value of the company to pass on to his/her issue, the foregoing does not apply with respect to the voting control over Freezeco. In that case, any one of the three options below may ensure that the Freezor retains voting control over Freezeco:

i) The preferred shares received by the Freezor on the estate freeze can be voting shares.
ii) The Freezor can subscribe for a separate class of voting preferred shares.
iii) The Freezor can be the sole trustee of the family trust.

Typically, the second alternative is the superior one to ensure that the Freezor will continue to maintain voting control.

<u>The Corporate Association Rules</u>

Once the Freezor's issue become shareholders of Frezeco, whether directly or indirectly through a family trust, this can cause association between Freezeco (and for that matter, any other corporations controlled by the Freezor) and any corporations controlled by the Freezor's issue[xl]. The association issue can be exacerbated even further where the common shares are held by a discretionary family trust, because:

i) each beneficiary of the trust is deemed to own all of the shares held by the trust[xli]; and
ii) if the discretionary family trust has beneficiaries who are minors, both parents are deemed to own the shares deemed to be owned by the minor beneficiary[xlii].

Therefore, careful consideration must be given to this technical issue, because while it may be desirable to immediately implement an estate plan for the Freezor, the association of otherwise unassociated corporations can result in additional annual costs thereafter. Such additional costs could arise, for example, from having to share the annual $500,000 small business deduction ("SBD") business limit, the $450,000 Ontario Employer Health Tax ("EHT") threshold before EHT is imposed, and the $3 million SR&ED expenditure limit for the higher refundable investment tax credits available to Canadian controlled private corporations ("CCPCs").

Estate freezes Post-2017: What Has and Has Not Changed?

When Finance Minister Bill Morneau had released his initial draft legislation on July 18, 2017 dealing with the taxation of owner-managed businesses and their family members, one of the areas which was targeted was the sprinkling of the LCGE among the beneficiaries of a family trust. For example, the proposals sought to preclude a capital gain realized by a trust from the sale of QSBC shares from being eligible for the LCGE claim by its individual beneficiaries, unless the trust qualified as an *Eligible LCGE Trust*[xliii]. Furthermore, the proposed amendments also contemplated that a capital gain which accrues while the QSBC shares are held by the trust, other than by an eligible LCGE trust, would no longer be eligible for the LCGE. Therefore, the traditional manner of having the common shares of a Freezeco (or its holding company) held by a family trust was a serious concern, since the tradeoff of doing so could have meant the loss of the entitlement to the LCGE, which would not arise if the Freezeco common shares would instead be owned directly by the individual beneficiaries. Fortunately, on October 16, 2017, the Department of Finance announced that it would abandon this aspect of the draft legislation.

One area of that draft legislation which did survive, albeit in a more relaxed form than what had originally been proposed on July 18, 2017, was the introduction of the December 13, 2017 amendments to the TOSI rules. Even if the primary reason for undertaking an estate freeze is the implementation of an estate plan for the Freezor, one can assume that future dividends will be paid to the Freezor's issue after becoming shareholders of Freezeco. Therefore, the manner in which future estate freezes are to be implemented, may very well have an impact upon whether such dividends are subject to the graduated rates of tax, or whether they will be subject to the TOSI rules at the highest rates of tax.

One area of the draft legislation which will likely have an impact upon how future estate freezes are to be implemented, and which may result in previous estate freezes being restructured, is in regards to the exclusion from the TOSI rules for *excluded shares* [xliv] held by an individual who is 25 years of age or older. The foregoing exception for excluded shares provides a relatively objective rule to enable family members to receive dividends from a private corporation and be subject to the graduated rates of tax, notwithstanding that the particular family members are not actively involved on a regular, continuous and substantial basis in the activities of the business[xlv].

To be considered excluded shares, three conditions must be satisfied under the proposed legislation. One such requirement is that the specified individual[xlvi] must own shares of the capital stock of the corporation giving him/her:

i) 10% or more of the votes that could be cast at an annual shareholders' meeting; and
ii) 10% or more of the FMV of all of the issued and outstanding shares of the capital stock of the corporation.

As may be noted, the definition does not contemplate indirect ownership of shares in satisfying this condition, nor is there a rule similar to subparagraph 256(1.2)(f)(ii) of the associated corporation rules, whereby ownership of shares by a discretionary trust will result in extended ownership of such shares by its beneficiaries. Therefore, if an estate freeze is undertaken whereby the common shares are thereafter held by a family trust, this will automatically preclude the dividends paid from the Freezeco to the family trust, and then from the family trust to its individual beneficiaries, from being derived from excluded shares[xlvii]. That said, even if the estate freeze was undertaken in a manner where the common shares were to be directly held by the Freezor's issue rather than a family trust, it may very well take several years until the common shares held by the issue will constitute excluded shares, since a significant portion of the FMV of the corporation's shares will likely be attributable to the class of preferred shares which the Freezor has received since the time of the undertaking of the estate freeze.

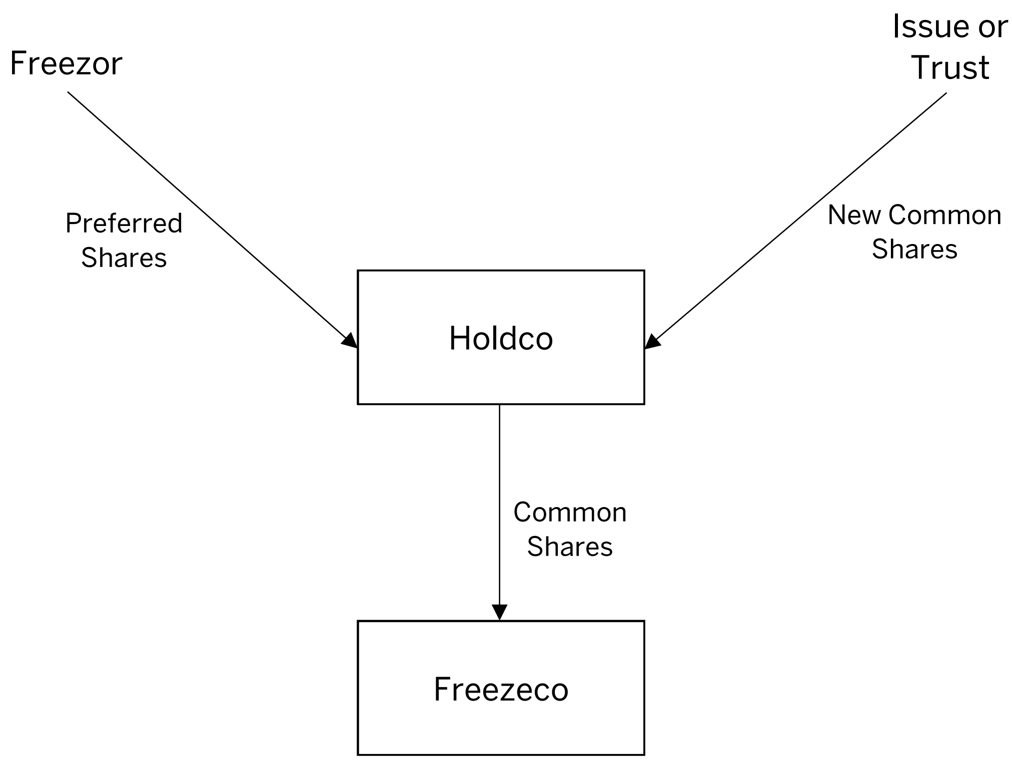
Beyond the TOSI rules, the 2018 Federal Budget announced two significant proposals to address the taxation of investment income by CCPCs, which were also originally proposed on July 18, 2017 but for which no actual legislation had been released at the time. One such proposal was the introduction of an additional mechanism for the clawback of the $500,000 SBD business limit[xlviii], should the *adjusted aggregate investment income* ("AAII") of an associated corporate group for its taxation years ending in the immediately preceding calendar year exceeds $50,000. The full clawback of the SBD business limit will arise where the AAII of the associated corporate group reaches $150,000 i.e. the clawback rate amounts to $5 for every $1 of AAII in excess of $50,000. This new Budget measure is to apply to CCPCs whose taxation year commences in 2019. In addition, whichever of the two clawback mechanisms results in the highest clawback of the SBD business limit for the particular calendar year will be the one which prevails.

As discussed earlier, undertaking an estate freeze can potentially associate corporations who were previously unassociated. While it is possible that the increased sharing of the $500,000 SBD business limit may not be an impediment to undertaking an estate freeze, since the corporate group may not earn greater than $500,000 of annual Canadian active business income at any rate, the recently announced investment income clawback measure will provide another angle for practitioners to consider in deciding whether to implement or suspend an estate freeze for a Freezor.

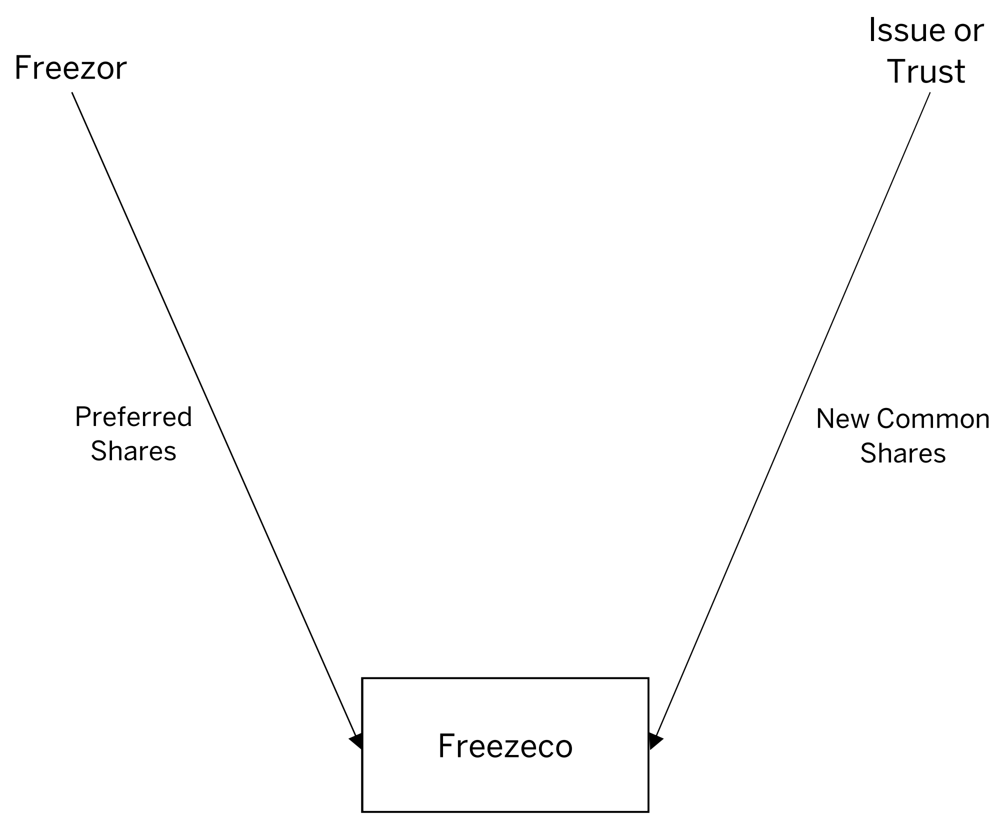
Conclusion

Notwithstanding the recently enacted amendments to the TOSI rules and the 2018 Federal Budgetary announcements, estate freezes will continue to be an integral part of a business owner's estate plan, albeit that the timing of its implementation and the manner in which the Freezeco common shares will be owned following the freeze will likely be impacted.

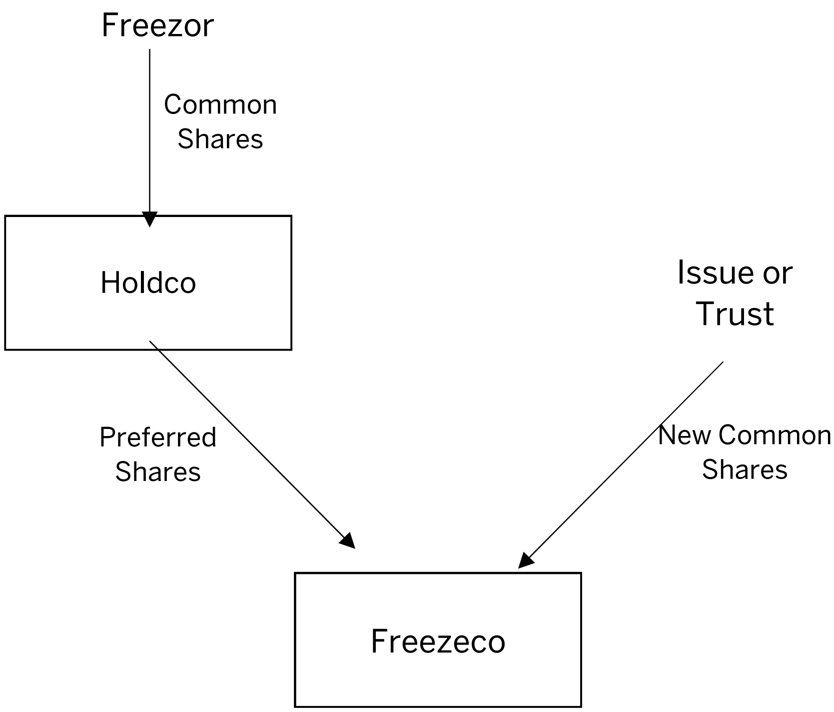
Estate Freeze: Transfer of Opco Shares to a Holdco
Appendix A



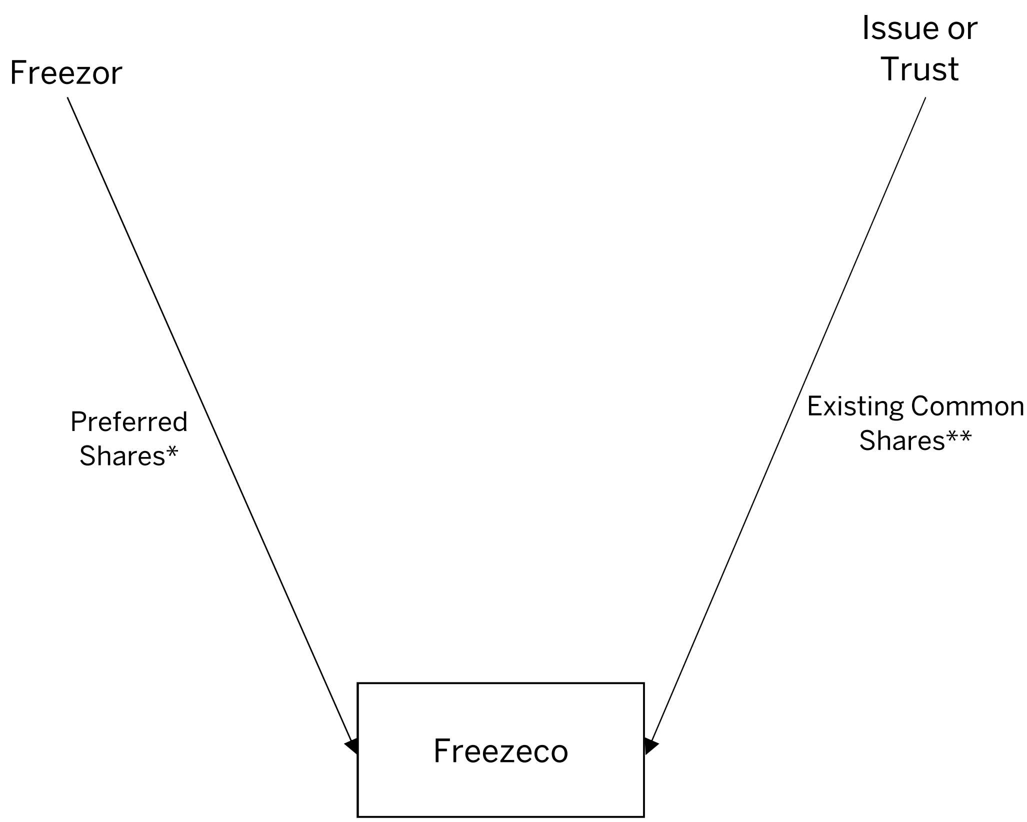
Estate Freeze: Share Reorganization
Appendix A



Estate Freeze: Corporate Freeze
Appendix B



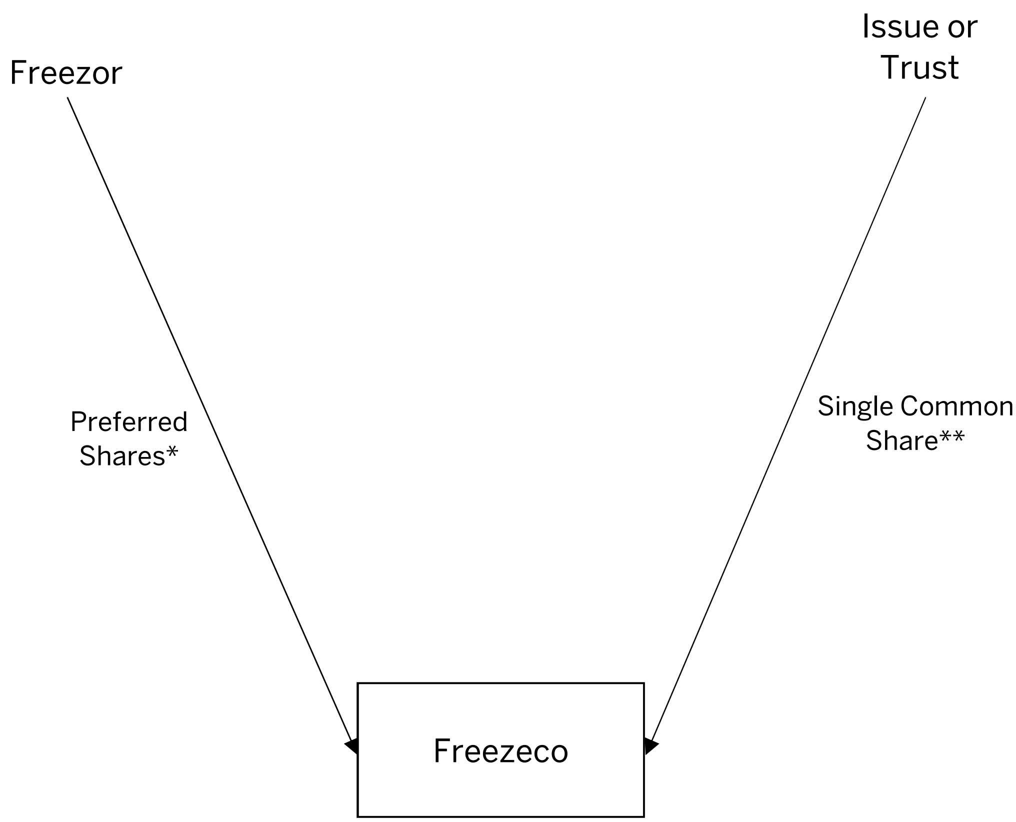
Estate Freeze: Stock Dividend
Appendix B



* Received as a stock dividend.

** Acquired by way of sale.

Estate Freeze: Section 51 Transaction
Appendix B



* Received in a share exchange to which subsection 51(1) applies.

** Acquired by way of sale.

[i] Tax Partner of Zeifmans LLP, Toronto, Ontario.
[ii] RSC 1985 c.1 (5th Supp.), as amended. All statutory references in this article, unless otherwise stated, are to the Income Tax Act.
[iii] To be hereafter referred to as the Freezor.
[iv] To be hereafter referred to as Freezeco.
[v] Pursuant to paragraph 70(5)(a). A similar rule exists for Canadian resource property, foreign resource property and land inventory of a business of the individual, pursuant to paragraph 70(5.2)(a). A preferred rule exists for the deemed disposition of class 14.1 property, pursuant to paragraph 70(5.1)(a).
[vi] A non-resident of Canada is deemed to dispose of his/her *taxable Canadian property* at that time, which could result in Canadian income tax implications arising. The focus of this paper will be on Canadian resident individuals, and therefore, this issue will not be elaborated upon any further.
[vii] Pursuant to subsection 70(6).
[viii] To qualify as a testamentary spousal trust, the last will and testament must provide that the taxpayer's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death, and no person except the spouse or common-law partner may before the spouse's or common-law partner's death, may receive or otherwise obtain the use of any of the income or capital of the trust.
[ix] Each of the major corporate reorganization statutory provisions (section 51,85, 86, and 87) contain such a rule.
[x] Pursuant to section 74.4.
[xi] As defined in subsections 251(2) – (6). Related for income tax purposes is not necessarily the same as the common expression of that term in our daily use of the English language. For example, uncles, aunts, nieces, nephews and cousins are not considered related for income tax purposes.
[xii] Equal to the lesser of: i) The FMV of his Opco shares, being $10 million; and ii) The sum of the ACB of the new shares received by virtue of paragraph 86(1)(a), being $1,000, and the Excess Amount of $4 million.
[xiii] 2017 DTC 1065, dated June 14, 2017. This particular case also dealt with the income attribution rule contained in section 74.1 and the anti-avoidance rule contained in subsection 74.5(11), but the foregoing will not be commented upon in this paper.
[xiv] While the case does not comment on this, it appears that the Minister never had reversed the tax assessments against Dr Mady's wife and daughters. Therefore, in this particular case, the foregoing events resulted in the utilization of a portion of Dr Mady's wife and daughters LCGE, notwithstanding that the same taxable capital gains were reassessed to Dr Mady. The foregoing action by the Minister is permissible, since the imposition of paragraph 69(1)(b) can ultimately result in double taxation under the law.
[xv] The foregoing is undertaken when the articles of incorporation or articles of amendment, as applicable, are drafted and then filed with the appropriate governmental authority.
[xvi] Designated person is defined in subsection 74.5(5). It includes a spouse or common-law partner, or a minor who does not deal at arm's-length with the individual, or is the niece or nephew of the individual.
[xvii] As defined in subsection 248(1).
[xviii] As defined in subsection 248(1), subject to certain modifications of that definition, as indicated in paragraph 74.4(2)(a).
[xix] As defined in subsection 74.4(3).
[xx] As defined in Regulation 4301(c).
[xxi] Other than dividends deemed by section 84.
[xxii] As defined in subsection 74.4(1).

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[xxiii] As defined in subsection 120.4(1).
[xxiv] As determined in accordance with section 120.4.
[xxv] Under the recent amendments to the TOSI rules released by the Department of Finance on December 13, 2017, a capital gain derived from the sale of QSBC shares is considered an *excluded amount*, and therefore, is not subject to the TOSI. The fact that a subsection 74.4(4) type clause would also preclude the ability to sprinkle any dividend income amongst the trust's beneficiaries who are designated persons of the Freezor is not as problematic, since more likely than not, that dividend income would be considered split income subject to the TOSI rules at any rate.
[xxvi] Because there exists a back to back loan and transfer rule in subsection 74.5(6), it would not be possible as part of the series of transactions to insert a holding company and then undertake the estate freeze in the manner described above, in order to avoid the corporate attribution rule.
[xxvii] By virtue of the definition of an amount, in accordance with subsection 248(1).
[xxviii] By virtue of paragraph 51(1)(c).
[xxix] For subsection 86(1) to apply to a share reorganization, it is required that all shares of a particular class of the capital stock of a corporation be disposed of by the taxpayer. Since in this particular instance, the Freezor is still retaining a single common share of Freezeco, subsection 51(1) would apply to the share reorganization, rather than subsection 86(1).
[xxx] Presumably this single common share will be of a nominal value, since there will be income tax implications to the Freezor, given that there will be a disposition of the common share at its fair market value for income tax purposes, pursuant to paragraph 69(1)(b). If the common share sold is a QSBC share, then presumably all or a portion of the resulting capital gain can be sheltered from tax by the Freezor's LCGE at that time.
[xxxi] In accordance with paragraph 110.6(1)(b), QSBC definition.
[xxxii] From a personal perspective, the only time I do not favor doing so, is if a particular child is active in the business and the parent wants to reward such child with share ownership in the operating company due to their own merit, rather than by virtue of their family namesake. In that case, it makes sense to award such shares directly to the child, no different than how one would have to deal with an arm's-length employee of the company.
[xxxiii] Generally speaking, a trust is deemed to dispose of its capital property and certain other property on the 21st anniversary of its creation, and every 21 years thereafter, by virtue of subsection 104(4). The typical manner in which a personal trust avoids this potentially adverse income tax consequence is to transfer its property to its beneficiaries in advance of this 21st anniversary on a tax-fee rollover basis, in accordance with subsection 107(2).
[xxxiv] The tax benefits associated with dividend sprinkling among beneficiaries of a family trust who are not actively involved in the business of the corporation whose shares are owned by the family trust have been significantly curtailed, due to the recent amendmebts to the TOSI legislation realeased on December 13, 2017.
[xxxv] Subsection 75(2) applies where a Canadian resident trust holds property on condition that it or property substituted therefor may revert to the person from whom the property was received, pass to persons to be determined by that person at any time subsequent to the creation of the trust, or that the property shall not be disposed of except with the person's consent or in accordance with the person's direction.
[xxxvi] The foregoing is often desirable for two reasons: i) it permits the parent to be in a position to unwind the freeze, if he/she so desires; and ii) it permits the parents the opportunity to benefit from the future growth in value of Freezeco.
[xxxvii] It should be noted that a trust to trust transfer does not necessarily extend the period of time when the deemed disposition of the property on the 21st anniversary of the first trust arises, by virtue of subsection 104(5.8).
[xxxviii] By virtue of subsection 107(4.1), which generally precludes a tax-free rollout of trust property in accordance with subsection 107(2). What should be noted is that if subsection 75(2) ever applied to

the trust, it precludes the tax-free rollout of any trust property, not merely the trust property, or property substituted therefor, which gave rise to the application of subsection 75(2).
[xxxix] As established by the case of Her Majesty the Queen v. Peter Sommerer (2012 DTC 5126).
[xl] By virtue of paragraphs 256(1)(c) – (e).
[xli] By virtue of subparagraph 256(1.2)(f)(ii).
[xlii] By virtue of subsection 256(1.3).
[xliii] As had been proposed to be defined in an amendment to subsection 110.6(1).
[xliv] As defined in the proposed amendment to subsection 120.4(1).
[xlv] Those family members who are actively engaged on a regular, continuous and substantial basis in the activities of the business will likely be exempt from the amended TOSI rules, because the dividends received from the particular corporation will be derived from an *excluded business* of the particular individual.
[xlvi] As defined in amended subsection 120.4(1).
[xlvii] This will not, however, preclude such dividends paid from the Freezeco to the family trust from being derived from an excluded business, because subparagraph (e)(ii) of the definition of an *excluded amount* contained in amended subsection 120.4(1), contemplates the direct or indirect payment of such income to the individual.
[xlviii] The first SBD clawback mechanism is where the taxable capital of the associated corporate group for its taxation years ending in the preceding calendar year exceeds $10 million, by virtue of subsection 125(5.1). A complete clawback of the $500,000 SBD business limit will arise where the taxable capital of the associated corporate group for its taxation years ending in the preceding calendar year amounts to $15 million or more i.e. the SBD business limit is clawed back at a rate of $1 for every $10 of taxable capital in excess of $10 million.