

The TaxLetter®

Vol. 38, No. 2

Your Guide to Tax-Saving Strategies

February 2020

TAXSTRATEGY

Estate Planning

Refreeze your business

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In the November 2019 TaxLetter issue, I discussed how estate freezes were still a good planning tool for family-owned businesses. One discussion point I did not mention was that estate freezes are also a good strategy if your business had gone down in value, or is currently experiencing a dip since you can freeze your interest in the operating business (“Opco”) at a lower value thus creating a lower tax bill on your death. But what if your business is in a low swing right now, but you’ve already implemented an estate freeze years ago at a time when values were higher? So on paper, your freeze value

in Opco is worth more than the entire value of Opco. The answer? Refreeze.

What is a Refreeze?

As discussed in my article back in November, an estate freeze contemplates freezing your value in an Opco at the current value at that time, such that any future growth in Opco would be diverted to the next generation (usually by way of a discretionary family trust). A “refreeze” is exactly what you think it sounds like: implementing a new estate freeze in Opco to freeze your value in Opco at the current (and lower) value. The process is relatively simple.

Assuming you implemented an estate freeze 10 years ago, you currently hold preferred shares of Opco that were frozen at the value of Opco at that time, let’s say \$5 million. Let’s

assume you gave new growth shares in Opco to a discretionary family trust. Now, 10 years later, you find that Opco’s value in total is only worth \$4 million. We would simply reorganize the share capital of Opco so that your \$5 million preferred shares are exchanged for new preferred shares equal to the current \$4 million value. New growth shares would be given to the family trust (or a new trust – see discussion below). What we have done is now lowered the value of your preferred shares, which in turn means lower death tax upon your passing. Of course it’s hopeful that Opco will now grow in value once the recession is over, and all future growth will pass to the family trust (i.e. the next generation). So you have effectively limited the capital gains tax that your estate will have to pay on your death by decreasing your assets by \$1 million.

Other benefits of a refreeze

Limiting your death tax bill is only one of the benefits you’ll get when implementing a refreeze. Without a refreeze, you could be jeopardizing the ability to take sprinkle income to certain family members. Alternatively, you may be able to take advantage of extending the tax-life of a family trust, or even better, protect the family assets from any potential claims by an ex-spouse.

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Income splitting

Although the ability to income split through a private company and your family members has been significantly curtailed with the introduction of the “Tax on Split Income” (TOSI) back in 2018 (see my numerous articles on this topic for a more detailed discussion), there may still be the ability to income split in certain limited situations. For example, if your family members are actively engaged in the business (i.e., a minimum of 20 hours a week), or they each hold, directly, more than 10 per cent of the votes and value of Opco (which is not a services business) and your children are 25 years or older, then you may be able to income split by paying dividends to them if they are in a lower tax bracket. If, however, the value of Opco has been reduced to below the value of your freeze value, then the ability to declare dividends may be limited under corporate law – i.e. dividends cannot be paid if there is insufficient value in Opco to satisfy the value of the freeze shares. Accordingly, by refreezing, you are lowering the value of the freeze shares, and thereby enhancing the ability to continue to income split by declaring dividends on the growth shares for the next generation (assuming your structure meets the limited exceptions to the TOSI rules).

Extending the Life of a Trust

As you may be aware, a discretionary family trust will be

subject to the “21 year rule”. Essentially, on the 21st anniversary of a trust, CanRev will treat the trust as having a deemed disposition i.e., the trust will be deemed to have sold all of its assets and reacquired those assets at the fair market value. Which translates to a capital gains tax bill to the trust. Accordingly, tax and trust practitioners always advise that you should take steps to distribute the assets out of the trust prior to the 21st anniversary to avoid this deemed capital gain. The good news is that the assets can be distributed to the beneficiaries on a tax-deferred basis as a general rule, assuming that the beneficiaries are Canadian residents (and assuming the trust has not been tainted by other tax issues – speak to your advisor to ensure the trust has not tripped in any of these rules). However, despite what you may initially think, 21 years sometimes passes quicker than you may like.

So, let’s go back to my initial example where you had frozen Opco 10 years ago and are considering a refreeze for the reasons already discussed. Rather than giving the new growth shares to the existing trust, which is already 10 years into its 21 years, you can create a new family trust and issue new growth shares to the new trust and “reset the clock” on the 21 years. So rather than having to distribute the share of Opco from the old trust within 11 years, you can now sit back for another 21 years before you have to think about any such distribution.

Family Law

A potential non-tax reason for refreezing could be related to protecting the family business from marital claims on the breakdown of your son or daughter’s marriage. Under Ontario family law, gifts after marriage will be excluded from marital claims for the division of property, if the proper language is included in the gift. If your children are not married at the time of the original estate freeze, your kids’ interest in Opco (owned directly or through a discretionary family trust) could be subject to a marital claim. However, if your kids subsequently get married, you may want to consider refreezing, and gifting new growth shares to your kids (or the trust of which they are beneficiaries).

In this manner, the new growth shares would be considered a gift after marriage and could potentially be excluded from any claims by spouses upon a marriage breakdown. If this strategy hits close to home for you, then I would caution that you should discuss this type of restructuring with a family lawyer to ensure that you are properly protected under the current family law rules. This is because family courts are known to be “courts of equity”, meaning that a properly implemented refreeze may be seen as unfair to the new spouse, and still not offer the protection you would like. In short, although there may be some planning opportunities with a refreeze, you should consult an actual family lawyer before implementing a refreeze. □