FREEZING, THAWING, AND REFREEZING: THE INTRICACIES OF AN ESTATE FREEZE

By: Martin J. Rochwerg & Krystle A. Ng-A-Mann

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1. INTRODUCTION

Estate freezing has been a very popular mechanism used in estate and succession planning for an owner-manager of a privately held corporation or an investor with an asset portfolio. To be effective to defer tax liability upon death, however, an estate freeze at a particular point in time assumes an increase in value of the frozen holdings in future years. Given the current economic climate, this presupposition has proven to be a premature miscalculation for some estate freezes that have been implemented in recent years. As such, it is a prudent course of action for a taxpayer to look for ways to offset the negative impact of a previously undertaken estate freeze, or to consider conducting an estate freeze for the first time now, while the economy continues to head south.

In this chapter, the authors first canvass the concept of estate freezing, since contemplating this type of estate planning for the first time is as relevant as ever as values hover at recent lows. Next, the authors explore ways in which to modify an estate freeze, such as re-freezing, melting, and thawing. Finally, this chapter concludes with a discussion of the Canada Revenue Agency ("CRA") administrative policy with respect to estate re-freezing, and an overview of the case law affecting estate freezing.

2. ESTATE FREEZING BASICS: THE TIP OF THE ICEBERG

The topic of estate freezing is extremely broad, and no attempt is made in this chapter to provide a comprehensive analysis with respect to estate freezing, as this has previously been the subject of a number of articles, papers and books.[1] Instead, a high level overview of the mechanics of estate freezing is provided herein to afford the reader a general understanding of the subject matter.

2.1 What is an "Estate Freeze"?

"Estate freeze" is a term used to describe a basic reorganization in which the value of an enterprise is "frozen" in fixed-value preferred shares equal to the fair market value ("FMV") of the business or holdings at the date of the freeze, allowing the future growth in value of a corporate entity to be attributed to common shares held by others, such as children or a family trust. A variety of procedures may be employed to accomplish an estate freeze for an individual, ranging in complexity from a simple exchange of assets to more complicated corporate reorganizations. An estate freeze achieves a number of goals, both tax-related and otherwise, such as the minimization of capital gains tax upon death.

The minimization or deferral of capital gains tax upon death is possible because an estate freeze enables the freezor to avoid paying capital gains tax on the entire amount of the future increase in a corporation's value, which would otherwise occur as a result of the deemed disposition rule

[1] See e.g. Martin J. Rochwerg and Maureen Y. Berry, "The Art of Estate Freezing", *Current Trends in Estate Planning*, (Toronto: The Canadian Institute, 1990); Martin J. Rochwerg and Maureen Y. Berry, "Unfreezing an Estate", *Estate Planning New Developments, New Tax Strategies* (Toronto: Insight Press, 1993)

in subsection 70(5) of the *Income Tax Act* (Canada) ("*ITA*" or the "*Act*").[2] Subsection 70(5) of the *ITA* provides that when a taxpayer dies, he or she is deemed to have disposed of his or her property immediately before his or her death for proceeds equal to the FMV of such property immediately before death. This subsection effectively creates a deemed disposition of certain types of property of the taxpayer immediately before his or her death and consequently triggers the realization of any capital gains that have accrued to date.

Assume, for example, that in Year 1 an individual (the "freezor") subscribes for 100 common shares in a corporation for $100 and leverages its undertakings. The adjusted cost base ("ACB") and paid-up capital ("PUC") of the freezor's 100 common shares are each $100. If in Year 10, the value of the corporation has grown to $5,000,000, and it is anticipated that the value of the corporation will continue to increase, it would be advisable for the freezor to lock-in or fix the value of the freezor's shareholding in the corporation in order, among other things, to minimize the amount of capital gains tax triggered on death. The freezor could exchange the freezor's common shares in the corporation for fixed-value preferred shares with a value equal to the FMV of the corporation in Year 10. The common shares, to which the future increase in value of the corporation would accrue, could then be acquired by others for a nominal cost. In this way, the capital gain that would be realized by the freezor upon death would be limited to the difference between the value of the corporation at the date of the freeze ($5,000,000) and the ACB of the freezor's shares ($100) (i.e. $5,000,000 - $100 = $4,999,900), one half of which would be included in computing the freezor's income for the taxation year (i.e. $2,499,950).

If, on the other hand, an estate freeze had not been implemented in Year 10, and the value of the corporation would have risen to $10,000,000 by the date of the freezor's death, then the capital gain realized upon death would be equal to the difference between the FMV of the shares at the date of death ($10,000,000) and the freezor's original ACB in the shares ($100) (i.e. $10,000,000 - $100 = $9,999,900), one half of which would be included in the freezor's income for the taxation year (i.e. $4,999,950).

As a corollary to limiting the amount of the capital gain triggered upon death to the difference between the value of the corporation at the date of the freeze and the ACB of the freezor's common shares, there is a capital gains deferral equal to the difference between the value of the corporation at the freezor's death and the value of the corporation at the date of the estate freeze. The tax deferral is not permanent, but will be effective until such time as the common shares are disposed of by the common shareholders, whether by death or otherwise (discussed below).

2.2 Tax Considerations

Aside from the minimization and deferral of capital gains tax, there are other valuable tax benefits to conducting an estate freeze, such as:

- minimizing probate fees;
- enabling family members to become shareholders and to contribute to the future growth of the corporation at a minimal cost to them;

[2] R.S.C. 1985, c. 1 (5th Supp.), as amended [*ITA*].

- income-splitting opportunities through taking advantage of other family members' lower marginal income tax rates;
- multiplying the use of the lifetime capital gains exemption ("LCGE"); and
- providing access to/crystallizing the LCGE for the original shareholder.

Certain of these benefits will be discussed in turn.

(a) Enabling Participation in Future Growth

An estate freeze is a beneficial mechanism for enabling family members to participate and share value in a family business. Since the common/growth shares are normally issued for nominal value, family members can acquire and hold equity in the family business for little consideration. This is intuitive, since the one of the primary intentions of executing an estate freeze is to have as much future growth attributable to the common shares as possible and to thereby maximize the amount of the capital gains deferral at the instigation of the freezor.

(b) Income-Splitting

An estate freeze also presents income-splitting opportunities for family members, causing income and capital gains to be taxed at a potentially lower marginal income tax rate of the common shareholders. Corporate distributions, such as dividends, and capital gains may arise from the freeze corporation and shareholdings and be taxed in the hands of lower tax bracket shareholders following the establishment of the estate freeze.

Although the benefits of distributing dividends has fluctuated over time and is contingent upon the disparity between the effective corporate and personal tax rate, as will be explored below, changes to the eligible dividend regime in Canada have made the distribution of eligible dividends an even more attractive option in recent times. Distributing dividends can also achieve the outcome of reducing the corporation's assets and maintaining a lower value in the corporation, where desirable.

The attributions rules in the *ITA* become an exceedingly important consideration when contemplating income-splitting opportunities, since certain income-splitting is precisely the type of mischief that the attribution rules were designed to target. Where applicable, they operate to require the transferor of certain types of property, rather than the transferee, to report the value of a distribution or income for taxation purposes. The personal attribution rules, "kiddie tax" and corporate attribution rules will be discussed immediately below, while the attribution rules relevant to trusts will be examined in section 2.4(d)(ii) of this chapter.

(i) Personal Attribution Rules

Property that is loaned or transferred (either directly or indirectly through a trust) to a spouse, child, niece or nephew, or any other individual that does not deal at arm's length with the transferor and who is under the age of 18 (a "non-arm's length minor") may fall within the ambit of the personal attribution rules in sections 74.1 and 74.2 of the *ITA*, respectively. If the attribution rules apply, then income or capital gains transferred to or for the benefit of a spouse will be attributable to the transferor, while income only (e.g. dividends) transferred to or for the benefit of a non-arm's length minor will be attributed to the transferor.

In the context of an estate freeze, this could occur, for example, where the growth shares of the freeze corporation are acquired by the spouse or minor child from the freezor, or money is lent by the freezor to the spouse or child for the purpose of acquiring the growth shares. However, if the loan to acquire the growth shares is made for value, then subsections 74.5(1) and 74.5(2) provide exceptions to the personal attribution rules. The interest on the loan for value must be charged at a prescribed rate[3], or at a rate to which arm's length parties would have agreed. In the alternative, a spouse or minor child may use his or her or their own independent funds to finance the share subscription.[4] In the further alternative, if the transfer of property is made for proceeds of disposition equal to the property's FMV, then subsection 74.5(1) will also shield the transaction from the attribution rules.[5]

(ii) "Kiddie Tax"

In terms of income-splitting with minor children, a freezor should be aware of the "kiddie tax" rules, another form of attribution rule, in section 120.4 of the *ITA*. According to subsection 120.4(2) of the *ITA*, effective for the year 2000 and later, 29% of the "split income"[6] of a child (i.e. a minor)[7] will be added to such child's income tax payable for the year. The minor's income tax will be calculated in accordance with subsection 120.4(3) of the *Act*. The "kiddie tax" rules apply to the income of a minor child attributable to dividends or shareholder appropriations from a privately held business, or income earned through a trust or partnership stemming from goods or services provided to a related person's business, but does not apply to capital gains. Effectively, the rules apply the top marginal income tax rate to such income in the hands of a minor.

(iii) Corporate Attribution

Where, for example, property is transferred or loaned to a corporation (as in an estate freeze), whether directly or indirectly through a trust, and one of the main purposes for doing so may reasonably be considered to have been to reduce the income of the transferor and to confer a

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[3] The prescribed rate for the 2nd, 3rd and 4th quarters of 2009 is 1%.

[4] In CRA Document Technical Interpretation No. 2001-0072705, dated May 8, 2001, CRA confirmed that if the shares held by a trust for minor children were acquired for an amount equal to their FMV and are paid for with funds that are not supplied by the freezor, then dividends paid on such shares held by the trust will not be subject to the attribution rule in subsection 74.1(2). See also *Romkey et al.* v. *The Queen*, 2000 DTC 6047 (F.C.A.) where the Court found that dividends paid on shares issued to a trust as part of an estate freeze for an amount other than their FMV were attributed back to the original shareholders.

[5] See CRA Interpretation Bulletin IT-510, "Transfers and loans of property made after May 22, 1985 to a related minor", dated December 30, 1987, and CRA Interpretation Bulletin IT-511, "Interspousal and Certain Other Transfers and Loans of Property", dated February 21, 1994, for a comprehensive discussion of the personal attribution rules as they relate to spouses and minors.

[6] See subsection 120.4(1) of the *ITA* for a definition of "split income".

[7] The "kiddie tax" rules apply to attribute the percentage of income tax to a "specified individual", which is also defined in subsection 120.4(1) of the *ITA*, and includes an individual who: (a) had not attained the age of 17 years before the year; (b) at no time in the year was non-resident; and (c) has a parent who is resident in Canada at any time in the year.

benefit on a "designated person", subsection 74.4(2) may apply to attribute to the transferor an amount of interest based on a prescribed rate. As mentioned above, a "designated person" is defined in subsection 74.5(5), and includes a spouse or common-law partner of the individual; or the child, niece or nephew, or other individual under the age of 18 that does not deal at arm's length with the individual.

In an estate freeze, it is not difficult to demonstrate that the main purposes may reasonably be considered to be the reduction the income of the transferor (e.g. the reduction of the capital gains tax liability on death) and the conferral of a benefit on a designated person (e.g. the conferral of the benefit of the future growth of the freeze corporation). In this way, subsection 74.4(2) may result in adverse tax consequences to the freezor.

For subsection 74.4(2) to apply, the following conditions must be satisfied:

- one of the main purposes for the transfer or the loan may reasonably be considered to be to reduce the income of the transferor and to directly or indirectly benefit a designated person (to so-called the "main purpose test");
- the designated person must be a "specified shareholder"[8] of the corporation;
- the transferor was a resident of Canada during the relevant period; and
- the corporation is not a "small business corporation"[9].

It should be noted that if any of the above conditions cease to apply, the corporate attribution rule will also cease to apply. To the extent that the corporation is a small business corporation, or certain other requirements are met where there is trust ownership, subsection 74.4(4) of the *Act* may apply so as to preclude attribution.

It can never be stressed enough that, while there certainly are ways to structure affairs to avoid invoking the various attribution rules and negative tax consequences ensuing therefrom, it is always recommended that professional tax advice be solicited in the context of planning in general, and estate freezing in particular.

(c) The Lifetime Capital Gains Exemption ("LCGE")

To the extent that the freezor's shares are considered "qualified small business corporation shares", a term defined in subsection 110.6(1) of the *ITA*, a significant portion of a capital gain realized on the disposition of such shares, including disposition on death, may be tax-exempt under the LCGE.

The LCGE enables individuals (not corporations) to shelter up to $750,000 of capital gains ($375,000 of taxable capital gains) arising out of the disposition of shares in a qualified small business corporation ("QSBC"), subject to certain restrictions. To be eligible to claim the

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[8] "Specified shareholder" is defined in subsection 248(1) of the *ITA* to include a person owning at least 10% of the shares of a "related corporation" other than a small business corporation.

[9] See subsection 248(1) for the definition of "small business corporation".

LCGE, the corporation whose shares are disposed of must be a Canadian-controlled private corporation (“CCPC”), which is a Canadian corporation that is not controlled (usually ownership of more than 50% of the voting rights) directly or indirectly by one or more non-residents, public corporations, or a corporation whose class of shares of its capital stock is listed on a designated stock exchange.[10] In addition, to qualify for the LCGE, at least 90% of the assets of the corporation must have been used to carry on an active business in Canada; and, in the 24 months preceding the sale of shares, the individual must have owned the shares personally and more than 50% of the corporation’s assets must have been used in an active business in Canada.

Concerns have been expressed that access to the LCGE in future will be restricted, or that the exemption will be repealed altogether. There may also be a concern that the freeze corporation will not continue to meet the definition of a QSBC, or the shares will not continue to be characterized as “qualified small business corporation shares”. Therefore, it is advisable to “crystallize” the freezor’s right to claim the LCGE, where possible, through an estate freeze.[11] Estate freezing also facilitates the multiplying of the LCGE in favour of those holding growth shares in the freeze corporation, and could potentially extend separate LCGE claims to all of the freeze beneficiaries. In a case where children of the freezor are the freeze beneficiaries, there is no concern that the personal attribution rules in section 74.1 of the *ITA* will attribute the capital gain back to the freezor, since subsection 74.1(2) does not apply to capital gains. Thus, the growth shares can be given to children, either directly or by means of a trust, for the purpose of multiplying the LCGE. On the other hand, the spousal attribution rule contained in subsection 74.1(1) will apply to income and capital gains, so particular attention must be paid in structuring the estate freeze to circumvent the application of the spousal attribution rule.[12]

If available, the LCGE is of considerable benefit to the freezor and other shareholders. However, it should be noted that the rules under the *Act* governing eligibility for the LCGE are extremely complicated, and there are many pitfalls to be aware of that are associated with claiming the exemption.

2.3 Non-Tax Considerations

Aside from the attractive tax-related opportunities discussed above, non-tax concerns are often a driving force in contemplating an estate freeze and deciding upon the method by which an estate freeze will be structured, and are therefore worthy of comment.

(a) Control

One of the most fundamental of these non-tax considerations is control of the corporation. The timing of an estate freeze is imperative, not only because of volatile market conditions, but also in ensuring the continued success of a business through the proper exercise of control, often at the hands of the freezor. Depending on the age of the freezor’s successors who acquire the common shares of the freezor’s corporation, the freezor may not wish for total control of the

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[10] See subsection 125(7) of the *ITA* for the definition of “Canadian-controlled private corporation”.

[11] For example, this could be done in an estate freeze by electing into a capital gain in respect of the freeze shares.

[12] This could be achieved, for example, by requiring the spouse to acquire the growth shares with independent capital. Since growth shares are usually acquired for a nominal amount, this will not be cost-prohibitive for such a freeze beneficiary.

business to pass to his or her successors. In such a case, it may be desirable for a freezor to retain partial control of the business through a partial freeze, where only some of the freezor's common shares are converted, or the freezor takes back consideration on the transfer that will allow him or her to participate in future growth. However, this may subvert some of the income tax objectives of estate freezing, since there is greater exposure to capital gains tax upon death under a partial freeze than there is under a full estate freeze.

In the alternative, it may be possible for the freezor to exchange his or her common shares for shares with specific control attributes attached to them. However, in subsequently exercising control, regard must be had for the rights of all of the shareholders not to be unduly prejudiced in the management of the corporation.

Generally, under Canadian corporate legislation, directors are required to act "honestly and in good faith with a view to the best interests of the corporation" and are required to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[13] Where, for example, control is exercised to the detriment of some or all of the shareholders, directors or officers, section 248 of the *Business Corporations Act* (Ontario) ("*OBCA*")[14] may provide relief to the shareholder(s), director(s) or officer(s) so prejudiced. Section 248 of the *OBCA*, the "oppression remedy", grants a court extensive powers to rectify situations in which a complainant[15] applies to the court, and the court is satisfied that the acts, omissions or affairs of the corporation or any of its affiliates, or the powers of the directors of the corporation or any of its affiliates have been or are threatened to be exercised in a manner that is oppressive, unfairly prejudicial or that unfairly disregards the interests of any security holder, creditor, director or officer of the corporation.[16] Section 241 of the *Canada Business Corporations Act* ("*CBCA*")[17] is the federal counterpart to section 248 of the *OBCA*, and contains nearly identical language to the *OBCA* provisions.

Section 207 of the *OBCA* also affords a court discretion to order the winding-up of a corporation in circumstances where, as in section 248 of the *OBCA*, the court is satisfied that the affairs of the corporation are conducted in an oppressive or unfairly prejudicial manner, or where the court believes it is "just and equitable" for some other reason. Moreover, subsection 190(3) of the *CBCA* empowers a minority shareholder to dissent and force the corporation to purchase his or her shares for an amount equal to their "fair value" in instances where he or she disagrees with a proposed fundamental change. These are but a few of the corporate law provisions that may

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[13] See e.g. subsection 122(1) of the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 [*CBCA*]; subsection 134(1) of the *Business Corporations Act* (Ontario), R.S.O. 1990, c. B.16 [*OBCA*].

[14] *OBCA*, *ibid*.

[15] "Complainant" is broadly defined in section 245 of the *OBCA* to include a registered or beneficial security holder of a corporation, a former registered or beneficial security holder of a corporation, a director, officer, former director, former officer of the corporation or any of its affiliates, or any other person, within the discretion of the court, who is a proper person to make an application to the court.

[16] See e.g. *Naneff* v. *Con-Crete Holdings Limited et al.*, [1995] O.J. No. 1377 (C.A.), an oppression remedy case where a son was successful in alleging that his father had acted in an oppressive manner in terminating his employment in the corporation subsequent to an estate freeze in which the father received a class of control shares in the corporation. The remaining shareholders were therefore required by the Court to purchase the son's shares for an amount equal to their fair market value.

[17] *CBCA*, *supra* note 13.

affect the validity of an estate freeze or subsequent modification that a freezor (owner-manager) should bear in mind.

Hence, while a freezor's main objective in implementing an estate freeze is to assign the growth value of the corporation to others (the "freeze beneficiaries"), the freezor should be aware that, in doing so, he or she is enabling the freeze beneficiaries to acquire shares, which are comprised of a bundle of rights and privileges in respect of the corporation, including participation in the decision-making therein. To the extent that a shareholder's "reasonable expectations" with respect to the administration of the corporation are offended, the freezor's original intentions in carrying out the estate freeze may be thwarted.[18]

Another method of preserving control is for the freezor to effect an estate freeze on a post-mortem basis, whereby the freezor's Will sets out the terms by which the freezor's assets in the corporation will be restructured and future growth allocated. However, insofar as the freezor is concerned, post-mortem estate freezing does not provide a reduction and deferral of capital gains tax, and may therefore postpone the primary benefit of instituting an estate freeze.

(b) <u>Sufficiency of Assets</u>

In addition to control, other non-tax considerations are the sufficiency of assets retained by the freezor and the financial consequences of an estate freeze. Due to inflation, changing market conditions, and longer life expectancy, a freezor may come to realize that there is inadequate value in his or her retained shareholdings to ensure an adequate lifestyle during retirement, and freezing prematurely may have a significant impact on the freezor's needs. The freezor may thus have to adjust to a different standard of living, or approach the freeze beneficiaries to ask for help or discuss other options. This may be challenging for the freezer if the relationship between the freezor and the freeze beneficiaries has deteriorated.

Estate freezing can become a challenging foray as a result of the interplay of the above-mentioned factors; and that can be compounded where family breakdowns occur following the execution of an estate freeze. In all cases, elucidating and managing the reasonable expectations of all parties involved is crucial. As much as possible, these ought to be sufficiently documented (e.g. in the form of a shareholder's agreement[19]) in advance of the estate freeze in order to avoid any misapprehensions, and in the event a court is compelled to make a determination with respect to the reasonable expectations of the parties.

Ultimately, estate freezing is done on a case-by-case basis, and a careful examination of the particular circumstances of the prospective freezor should be carefully undertaken before an estate freeze is executed.

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[18] See e.g. *Animal House Investments Inc.* v. *Lisgar Development Ltd.*, [2008] O.J. No. 2240 (S.C.J.); aff'g (2007), 87 O.R. (3d) 529 (S.C.J.), where the Court refused to order the purchase of a son's shares by his mother and sister (the remaining shareholders) under section 207 of the *OBCA* because the son failed to demonstrate that he had a reasonable expectation that the corporation would be wound up or his shares would be purchased in circumstances where there were irreconcilable differences between the parties involved.

[19] Note, however, that a court's arsenal of remedies in a s. 248 oppression action includes "creating or amending" a unanimous shareholder agreement pursuant to paragraph 248(3)(c) of the *OBCA*.

2.4 Effecting an Estate Freeze

As mentioned, there are many variations for implementing an estate freeze, which can range considerably in degree of complexity. In this section, estate freezing through the rollover provisions in sections 85 and 86 of the *Act* will be addressed as well as the option of utilizing an *inter vivos* trust. The particular method selected by the prospective freezor will depend on his or her circumstances, and the circumstances of the others involved, such as the prospective freeze beneficiaries.

(a) Section 85 Rollover

Section 85 of the *ITA* facilitates the transfer of certain types of property, including shares, to a corporation on a rollover basis, such that no immediate income tax liability is incurred by the transferor on the transfer, but is instead shifted to the transferee corporation. In Interpretation Bulletin IT-291R3 ("IT-291R3")[20], CRA sets out the criteria that must be satisfied in order to be eligible for the subsection 85(1) rollover:[21]

- the transferee corporation must be a "taxable Canadian corporation";
- the property transferred must be "eligible property";
- a joint election must be filed by the transferor and the transferee corporation; and
- the consideration received by the transferor must include at least one share of the capital stock of the transferee.[22]

The transferor can be an individual or a corporation. On the other hand, the transferee must be a "taxable Canadian corporation", which is defined in subsection 89(1) of the *ITA* to mean a corporation that was resident at the relevant time of the transfer, that was either incorporated or resident in Canada between June 18, 1971 and the date of the transfer, and that is not exempt from Part I tax. "Eligible property" is defined in subsection 89(1.1) of the *Act* to include, *inter alia*, shares of the capital stock of a corporation. The joint election by the transferor and transferee must be filed within the requisite time[23], on the prescribed form (T2057), and must specify the agreed amount for which the transfer will have occurred.[24]

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[20] CRA Interpretation Bulletin IT-291R3, "Transfer of Property to a Corporation under Subsection 85(1)", dated January 12, 2004 [*IT-291R3*].

[21] See also CRA Information Circular IC 76-19R3, "Transfer of Property to a Corporation under Section 85", dated June 17, 1996 [*IC 76-19R3*].

[22] *IT-291R3*, *supra* note 20 at para. 1; *IC 76-19R3*, *ibid.* at para. 8.

[23] See subsection 85(6) of the *ITA*.

[24] In particular, pursuant to paragraph 85(1)(c), the agreed amount cannot be greater than the FMV of the property disposed of, and cannot be less than the FMV of the non-share consideration received in exchange under paragraph 85(1)(b) of the *ITA*. If the FMV of the transferred property exceeds the value of the consideration received by the transferor and the agreed amount, and it is reasonable to regard any part of the excess as a benefit that the transferor wished to confer on a related person, then subsection 85(1)(e.2) may apply to increase the agreed amount: *IT-291R3* at paras. 10 & 18. Note, however, that subsection 85(1)(e.2) does not apply in a case where the transferee is a wholly-owned corporation of the transferor.

Assuming the conditions in subsection 85(1) are met, the freezor can transfer his or her common shares to the freeze corporation in exchange for preferred shares by filing a joint election with the freeze corporation; or the freezor can transfer his or her common shares to a holding corporation in exchange for preferred shares of the holding corporation on a tax-deferred basis under subsection 85(1). Both variations are commonly used.

The effect of the election is to deem the transferor's proceeds of disposition, and the freeze (or holding) corporation's cost of the common shares, to be the agreed amount. At the same time, paragraph 85(1)(g) of the *ITA* provides that the cost of the preferred shares to the transferor that are received as consideration for the common shares disposed of will be deemed to be the lesser of: (a) the FMV of the shares immediately after the transfer; and (b) the elected proceeds of disposition minus any non-share consideration. If preferred shares of more than one class are received by the freezor, then the amount assigned to each class will be determined on a *pro rata* basis.

In allowing an "agreed amount" to be selected under subsection 85(1), this rollover provision permits a freezor to select the amount of capital gain that he or she would like to trigger at the time of the rollover, if any, perhaps making use of the LCGE or offsetting the gains with capital losses.

(b) <u>Section 86 Share Reorganization</u>

Section 86 involves an internal reorganization of share capital where a freezor's common shares in the freeze corporation are exchanged for preferred shares. Under section 86, the freezor must dispose of all of his or her shares of any particular class of the capital stock of a corporation in the course of the reorganization to be eligible for the rollover. Section 86 and section 85 are mutually exclusive, since subsection 86(3) of the *Act* states that section 86 does not apply where subsection 85(1) applies.

As in a section 85 rollover, there may be non-share consideration received as part of the proceeds of disposition of the common shares. However, under section 86, there will not be a complete rollover insofar as the value of the non-share consideration exceeds the ACB of the common shares exchanged; and where the non-share consideration exceeds the PUC of the common shares, there will be a deemed dividend under subsection 84(3) of the *Act* which will be excluded from the proceeds of disposition of the common shares.

Where non-share consideration is received by the freezor as all or part of the consideration for the disposition of the common shares, then the ACB of the non-share consideration is deemed to be the FMV of the non-share consideration at the date of the disposition under paragraph 86(1)(a). Pursuant to paragraph 86(1)(b), the amount by which the original ACB of the common shares disposed of exceeds the FMV of the non-share consideration is deemed to be the freezor's ACB of the freeze shares.

In effecting a section 86 rollover, subsections 86(2) and 15(1) of the *Act* must be observed. Subsection 86(2) may apply to the rollover where the freezor has disposed of his or her common shares in the freeze corporation and the value of the shares and any non-share consideration is less than the FMV of the exchanged common shares, and it is reasonable to regard any portion of the difference as a benefit that the freezor desired to confer on a related person. The effect of subsection 86(2) is to limit the rollover and reduce the cost of the new freeze shares. If, on the other hand, the value of the shares plus non-share consideration received in exchange for the common shares is greater than the FMV of the common shares, then there may be a shareholder benefit under subsection 15(1). If the freezor only receives shares in return for the common shares, then the ACB of the freeze shares received by the freezor will be the same as the ACB of the exchanged shares.

As mentioned, to avail himself or herself of the section 86 rollover the freezor must dispose of all of the shares of a particular class of shares of the capital stock of the corporation, and must receive property from the freeze corporation that includes other shares of the corporation's capital stock (but not necessarily of the same class of the shares exchanged). In addition, the common shares exchanged in the rollover must be held by the freezor as capital property, not inventory.

One of the disadvantages in using a rollover provision to execute an estate freeze is that the freezor will be unable to crystallize his or her LCGE unless an appropriate election is jointly filed by the freezor and the freeze corporation under the section 85 rollover to deem the proceeds of disposition of the common shares to be the amount of the LCGE plus the original ACB of the shares.

Without the rollover provisions in sections 85 and 86 of the *ITA*, the disposition of shares that occurs on the reorganization of share capital under an estate freeze could be considered a taxable event. It must be remembered that in all cases, the constating documents (e.g. Articles of Incorporation) of the freeze corporation will generally need to be amended in order to provide for a new class of preference shares to be issued as part of the consideration.

(c) <u>Section 51 Share Conversion</u>

Yet another common method of implementing an estate freeze is through the use of a section 51 share conversion. A section 51 share conversion is substantially the same as a section 86 share reorganization in that a freezor exchanges his or her old shares for new shares in the freeze corporation without causing an immediate disposition giving rise to a taxable capital gain. Unlike a section 86 share reorganization, however, under section 51 the freezor is not required to dispose of <u>all</u> of the shares of a particular class of the freeze corporation. Section 51 allows convertible securities[25], such as shares, bonds, debentures or promissory notes to be exchanged.

It should be noted that subsection 51(2) of the *ITA* might be invoked to limit the rollover in situations where a taxpayer gifted a portion of the value of the convertible property to a related person. This may force the recognition of a capital gain and alter the ACB of the shares received on the conversion. Subsection 51(2) will apply where:

- subsection 51(1) would otherwise have applied to the conversion of shares;
- the FMV of the convertible property before the conversion is greater than the FMV of the shares received in exchange; and

[25] See CRA Interpretation Bulletin IT-96R6, "Options Granted by Corporations to Acquire Shares, Bonds, or Debentures and by Trusts to Acquire Trust Units", dated October 23, 1996 [*IT-96R6*] for a discussion about several aspects of convertible securities.

- such excess can reasonably be considered to be a benefit that the taxpayer wished to confer on a related person.

Typically, section 51 will not apply in circumstances where there is a triggering event creating an automatic conversion of the common shares, or the shares automatically convert on a specific date.[26] Section 51 will also not apply where section 85 or 86 applies.

(d) Utilizing a Discretionary Family Trust

The common shares to which the growth of the corporation accrues can be held in various ways, such as by individuals alone, a holding corporation, or through a discretionary *inter vivos* trust. The method of using a discretionary trust in estate freezing is also sometimes referred to as a "flexible freeze". Not surprisingly then, holding the common shares through a discretionary trust provides a great measure of flexibility to the freezor, and affords the beneficiaries of the trust only possible access to the income from the shares. The freezor, as settlor, can appoint the beneficiaries of his or her choice, including himself or herself as potential income beneficiary. If the freezor is established as the trustee of the trust, then the freezor can play a role in determining the amount and manner in which distributions are to be made.[27] As will be seen where the freezor is not the settlor, the use of a discretionary trust can also be a means of altering an estate freeze previously implemented, where the freezor, as beneficiary, can retain some of the benefit of the growth shares through receipts of income or capital out of the trust.

It is also possible for a testamentary trust to succeed to the freeze shares of the freezor, while an *inter vivos* trust holds the growth shares. This could enable the benefits flowing from the freeze shares to be provided to the freezor's spouse after he or she is deceased. The spousal trust is not subject to the same 21-year deemed disposition rule (discussed below) as an *inter vivos* trust.[28]

(i) 21-Year Deemed Disposition Rule

The efficacy of using a discretionary trust is limited by the 21-year deemed disposition rule in subsection 104(4) of the *Act*, which is designed to compel trusts to recognize and pay tax on their accrued capital gains every 21 years, and prevents trusts from avoiding taxation on an indefinite basis. Subsection 104(4) states that a trust is deemed to have disposed of its capital property for proceeds equal to their FMV on the 21st anniversary of the trust's establishment, forcing the

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[26] See "Revenue Canada Round Table", in *Report of the Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1988), 47: 51-103, question 67.

[27] See CRA Interpretation Bulletin IT-381R3, "Trusts -- Capital Gains and Losses and the Flow-Through of Taxable Capital Gains to Beneficiaries", dated February 14, 1997 [*IT-381R3*] for a complete discussion, among other things, of the tax treatment of capital gains and losses to a trust and its beneficiaries.

[28] Note that there are different rules for pre-1972 spousal trusts and post-1972 spousal trusts. For instance, a post-1972 spousal trust is not subject to the deemed disposition rule until the date of death of the spouse. See subsection 108(1) of the *ITA* for a definition of a "pre-1972 spousal trust". There are also different deemed disposition rules that apply to new trusts introduced into the *ITA* after 1991, which may permit a trust to later defer the deemed disposition. These should be consulted when using trusts in estate planning.

realization of capital gains accrued to date. There are, however, ways to limit the application of this rule.[29]

(ii) Trust Attribution Rules

When using an *inter vivos* trust in estate planning, the attribution rule in subsection 75(2) of the *Act* must be observed. In certain circumstances, the income of the beneficiary of the trust will be attributed back to the transferor. Where a person (including a corporation) transfers property to a trust and retains control of the transferred property as if the property was his, her or its own, then it may be possible for the income to be attributed back to the transferor. This could apply, for instance, where the freezor establishes a discretionary trust as settlor, and there is a reversionary right to the property in the trust.

Under subsection 75(2) there will be attribution of certain amounts derived from property held by a trust to the person from whom the property was received (whether directly or indirectly). In Interpretation Bulletin IT-369R ("IT-369R")[30], CRA states that any income or loss from the property, and any taxable capital gain or allowable capital loss from the disposition thereof will be attributed to the transferor where the terms of the trust provide that the property:

- may revert to the transferor[31];
- may be distributed to the beneficiaries as determined by the transferor after the trust's creation; or
- may only be disposed of with the consent or at the direction of the transferor, while alive.[32]

Note that there does not have to be an actual transfer of property to the trust by the person to whom income or gain is attributed under the terms of subsection 75(2), so long as the income is

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[29] One way in which the 21-year deemed disposition rule may be circumvented is by conducting a re-freeze (discussed at Section 3.1 of this chapter), where the common shares of the freeze corporation are frozen in advance of anticipated growth, and a new family trust subscribes for the new growth shares therein. If the common shares are retained at the 21st anniversary, then the deemed disposition and corresponding capital gain realized by the first trust under subsection 104(4) would then be limited to the difference between the FMV of the growth shares at the date of the re-freeze and their ACB.

[30] CRA Interpretation Bulletin IT-369R, "Attribution of Trust Income to Settlor", dated March 12, 1990 [*IT-369R*].

[31] CRA has previously expressed that even if there is a remote possibility that the property of the trust will be returned to the person who contributed the property to the trust in the first place, subsection 75(2) may apply: CRA Document No. 2006-0185571C6, dated September 11, 2006. In the context of a loan to a trust, it has been held that a *bona fide* loan, on its face, is not subject to subsection 75(2), since reversion occurs by operation of the terms of the loan, not the terms of the trust: *Howson* v. *The Queen*, 2007 DTC 141 (T.C.C.) [*Howson*]. As such, CRA later acknowledged *Howson* and retracted its previous position: CRA Document No. 2007-0240421C6, dated June 08, 2007.

[32] *IT-369R*, *supra* note 30 at para. 3; see also subsections 75(2)(a)(i), (ii) and 75(2)(b) of the *ITA*.

derived from property "held" by the trust.[33] Subsection 75(2) does not apply to income or loss from a business, and therefore does not attribute business income back to the transferor.[34]

Perhaps even more significantly, the interaction between subsection 75(2) and subsection 107(4.1) of the *Act* must be considered. Pursuant to subsection 107(4.1) of the *ITA*, where subsection 75(2) applies, or ever applied to a particular trust, the rollout of property of such trust to the capital beneficiaries will be estopped. Normally, under subsection 107(2) of the *Act*, a "personal trust"[35], which includes either an *inter vivos* or testamentary trust, is able to roll out its capital property on a tax-deferred basis to a beneficiary resident in Canada. One of the reasons for using a subsection 107(2) rollout is to avoid the 21-year deemed disposition rule. Therefore, where the freezor is the settlor of a discretionary trust that, as part of an estate freeze, holds the growth shares in the freeze corporation, and the freezor retains a reversionary right such that subsection 75(2) applies, subsection 107(4.1) will inhibit a distribution in satisfaction of a capital beneficiary's interest by nullifying a rollout.

Where possible, an *inter vivos* trust used in such estate planning should be irrevocable. Alternatively, the property of a reversionary trust may be transferred to a new trust that does not carry a reversionary right.[36] Another suggestion is for a person other than the freezor to be the settlor of the trust, where the freezor is going to be a trustee. However, CRA has opined that it might be possible for subsection 75(2) to apply to a person other than the settlor, where such person transfers property to a trust with such terms as have been enumerated above.[37]

Another important trust attribution rule is found in section 74.3 of the *Act*. Much like the personal attribution rules found in sections 74.1 and 74.2 of the *Act*, where an individual has lent or transferred property to a trust (whether directly or indirectly by means of a trust) in which a "designated person" is beneficially interested, then income and capital gains recognized by such a designated person will be attributed back to the transferor. "Designated person" is defined in subsection 74.5(5) to include a spouse, or person under the age of 18 who does not deal at arm's length with, or is a niece or nephew of, the transferor.

Accordingly, there are a number of attribution rules to be cognizant of when utilizing a trust in estate freezing or estate planning, in general. Aside from the income tax consequences that may arise, there are common law considerations applicable to trusts.

(iii) Trustee Duties and Obligations

There are certain common law duties and obligations that trustees must observe. Specifically, a trustee is obliged to act in the best interests of the beneficiaries, and has a duty to act even-handedly and solely for the benefit of the beneficiaries in the performance of the trustee's duties. The trustee may not act irresponsibly or capriciously.

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[33] CRA Interpretation Bulletin IT-369RSR, "Attribution of Trust Income to Settlor" (Revised), dated June 24, 1994 [*IT-369RSR*] at para. 1.

[34] *IT-369R*, *supra* note 30 at para. 5.

[35] See subsection 248(1) for a definition of "personal trust".

[36] CRA Document No. 2001-0067955, dated January 3, 2002.

[37] *IT-369R*, *supra* note 30 at para. 11.

The trustees are usually permitted, unless prohibited by the terms of the trust, to exercise the rights attached to any shares the trust owns, including voting rights, and may also dispose of such shares. Often times, a freezor has been appointed as the trustee under the discretionary trust, and will therefore be in a position to consent to a transaction, such as one of those discussed below, which modifies the initial freeze. The freezor will, however, be governed by the overarching common law duties to which trustees are normally subject in his or her capacity as trustee. As such, the freezor will be precluded from acting contrary to the best interests of the beneficiaries, and cannot engage in activities solely to satisfy the freezor's needs otherwise he or she will be in breach of his or her fiduciary duties. To that end, there are certain remedies available to beneficiaries so prejudiced, such as applying to a court for an order removing the trustee.[38]

(e) Freeze Share Attributes

A consideration of the freeze share attributes is extremely important in planning an estate freeze. Generally, freeze shares should have the same FMV as the common frozen shares at the date of the freeze so as not to attract adverse income tax consequences. The attributes of the freeze shares must sufficiently capture the FMV as at the date of the freeze, and this can be difficult to accomplish. This is important because it will militate against an argument that a shareholder benefit has been conferred on the freeze beneficiaries, for example.[39]

A usual feature of freeze shares is a redemption right which provides that the freeze shares may be redeemed by the freeze corporation for proceeds equal to the FMV of the assets exchanged for the freeze shares at the date of the freeze. Similarly, the freeze shares may carry a retraction right whereby the freezor can cause the freeze corporation to reacquire the freeze shares for proceeds equal to their FMV.[40] CRA has also opined that freeze shares should have a preferential dividend entitlement, should entitle the holder of such shares to vote on fundamental changes to share capital, and should afford the holder priority in a distribution on the dissolution, winding-up or liquidation of the corporation.[41]

It should also be noted that in terms of share characterization, the freeze shares resulting from an estate freeze are normally considered "taxable preferred shares" for taxation purposes. "Taxable preferred share" is defined in subsection 248(1) of the *ITA*, and includes, *inter alia*, most shares conventionally described as preferred shares. Normally, a dividend paid on a taxable preferred share would be subject to certain rules under the *Act*. However, these rules are not invoked in a classic estate freeze scenario where dividends are paid to the freezor, by virtue of the shareholder (freezor)'s control over the freeze corporation paying the dividends. If a freezor has a

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[38] See e.g. *Re Lithwick and Lithwick* (1975), 9 O.R. (2d) 643.

[39] See CRA Interpretation Bulletin IT-432R2, "Benefits Conferred on Shareholders", dated February 10, 1995 [*IT-432R2*] for a complete discussion of shareholder benefits.

[40] In CRA Document No. 9639985, dated May 1, 1997, CRA stated that the removal of a retraction feature from preferred shares suggests that the preferred shares do not have a value equal to their redemption amount.

[41] See e.g. "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Second Tax Conference*, 1980 Conference Report (Toronto: Canadian Tax Foundation, 1981), 591-628, question 13, at 602; "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 726-66, question 45, at 759; CRA Document No. 9229105, dated January 13, 1993; and CRA Document No. AC59387, dated February 26, 1990.

"substantial interest"[42] in the freeze corporation, then dividends on preferred shares held by the freezor (i.e. the freeze shares) will be considered to be excluded dividends, not exposed to certain tax liability.

3. ALTERING AN ESTATE FREEZE: "RE-FREEZING" AND OTHER OPTIONS

As the oft-quoted economic saying goes, "What goes down must come up". If there is any truth to this adage, it would be advisable to explore re-freezing options during the economic downturn. To maximize the amount of tax savings, it makes sense to fix the freezor's interest in a corporation when the corporation's value is at its lowest. However, the utmost amount of care and attention must be paid when altering or unfreezing an estate freeze, as any attempts to unwind an estate freeze may cause a realization of capital gains or other income.

In this section, in addition to the basic estate "re-freeze", other modifications, such as thaws, melts, and reverse freezes will be examined.

3.1 The Basic "Re-Freeze" in Challenging Economic Times

A "re-freeze" is a transaction whereby an existing freeze is altered, but not reversed. Essentially, a basic "re-freeze" involves converting, once again, the freezor's existing shares into a new class of shares valued at the current FMV of the corporation, or converting the freeze beneficiaries' growth shares into preferred shares with a redemption amount equal to the FMV of the growth shares at the date of the re-freeze. Typically, a re-freeze ascribes any growth up to the date of the re-freeze to the freeze beneficiaries, and growth beyond that point to either the freezor and/or new freeze beneficiaries ("re-freeze beneficiaries").

Using the same example outlined at Section 2.1 of this chapter, assume the ACB and PUC of the freezor's 100 common shares is $100. As in the previous example, in Year 10, the value of the freezor's corporation has risen to $5,000,000, an estate freeze is implemented, and the freezor now owns freeze shares valued at $5,000,000. Assume this time, however, that in Year 15, the value the freezor's corporation has declined to $100,000, but the value will hopefully rise again by the date of the freezor's death. At this point in time, it would be fruitful for the freezor to implement an estate re-freeze to further minimize the capital gain that would otherwise be triggered upon death as a result of subsection 70(5) of the *ITA*.

Under a basic re-freeze, the freezor could exchange his or her freeze shares with a FMV of $5,000,000 for new fixed-value preferred shares with a redemption amount equal to the freeze shares, being $100,000 ("new freeze shares"). As such, the capital gain triggered upon death will be limited to the difference between the FMV of the new freeze shares ($100,000) and the original ACB of the common shares ($100) (i.e. $100,000 - $100 = $99,900), one half of which is included in computing the freezor's income for the taxation year ($49,950), as opposed to the difference between the FMV of the freeze shares ($5,000,000) and the original ACB of the common shares ($100) (i.e. $5,000,000 - $100 = $4,999,900).

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[42] See subsection 191(2) of the *ITA* for a discussion of when a shareholder has a "substantial interest" in a corporation. One way of having a "substantial interest" is by being "related" to such corporation, which is defined in subsection 251(2) of the *ITA*.

In other words, whereas the capital gain that would otherwise be realized following an estate freeze in Year 10 without a re-freeze in Year 15 would be $4,999,900 (with a taxable capital gain equal to $2,499,950), the capital gain upon death following a re-freeze in Year 15 will be $99,900 (with a taxable capital gain of only $49,950)—a substantial reduction of $4,900,000, and $2,450,000 of taxable capital gain. Simply put, a re-freeze precludes any future growth in value of the freeze shares, and attributes such future growth to new freeze shares.

An economy such as in early 2009 can constitute a catalyst for a re-freeze. An obvious benefit to an estate re-freeze is locking in a minimized tax liability upon death for the freezor, resulting from the decrease in the amount of the deemed capital gain arising on death. Again, as a corollary, this produces an even larger capital gains deferral for the freezor, as the example above illustrates.

Another possible reason to re-freeze an estate is that as part of an estate freeze, the common shares will have been limited in the payment of dividends where the value of the company has been reduced below the freeze value. As such, a reduction in value of the corporation beyond that of the original freeze may hinder income-splitting opportunities going forward. In this way, re-freezing at the lower value of the corporation will advance the opportunity for the issuance of dividends on the common shares, and the reduction of tax liability by shifting the burden to potentially lower income earning spouses and children. This basically allows income-splitting to recommence sooner.

3.2 Implementing an Estate Re-Freeze

Since an estate re-freeze may be viewed simply as another estate freeze subsequent to the original, it should come as no surprise that the techniques to implement an estate re-freeze bear many of the same characteristics and utilize the same provisions of the *ITA* as those used to implement an initial estate freeze.

(a) Reverse Freeze (Section 85 Rollover)

As indicated at section 2.4(a) of this chapter, a section 85 rollover can facilitate the transfer of assets to a corporation in exchange for shares on a tax-free basis. Where an estate re-freeze is involved, the freeze corporation could transfer its assets to a new freeze corporation in exchange for preferred shares having a redemption amount equal to the FMV of the assets transferred.

"Reverse freeze" is another term used to describe a type of re-freeze arrangement where the assets of the freeze corporation are transferred to a new transferee corporation. The rollover provisions in subsection 85(1) could be used to transfer the assets to the transferee corporation. As consideration for the assets transferred, the transferee corporation issues freeze shares to the transferor (i.e. preferred shares having a redemption amount equal to the FMV of the transferred assets). Others parties, such as loved ones, could then subscribe for common growth shares in the new freeze corporation. Alternatively, the freeze corporation could subscribe for common shares in the new freeze corporation for a nominal amount.

The advantage of using this method of re-freezing is that it allows the freezor to choose which of the assets of the freeze corporation will be subject to the reverse freeze. In addition, the corporate attribution rule in subsection 74.4(2) (as discussed in section 2.2(b)(iii) of this chapter) will not apply to a reverse freeze because the transferor will be the freeze corporation, not an individual freezor. The courts have interpreted the actions of a corporation and its shareholder to be independent of one another; and hence, the freezor will not be seen to have transferred or loan property to a corporation indirectly through the freeze corporation, for the purposes of subsection 74.4(2).[43]

Normally, a section 85 rollover affords the transferor corporation a great degree of latitude to select the specific assets transferred. Where the section 85 rollover is in respect of all of the assets of the freeze corporation, then the approval of the shareholders of the freeze corporation will need to be obtained by special resolution otherwise shareholders may be entitled to a right of dissent. There may also be other tax considerations to keep in mind, such as whether provincial sales tax ("PST") and/or harmonized sales tax ("HST") is payable.

(b) Section 86 Share Reorganization

To execute a section 86 share reorganization, there must be a reorganization of share capital in which all of the shares of a particular class of the freeze corporation are disposed of, and other shares of the freeze corporation's capital stock (but not necessarily of the same class) must be received as at least part of the consideration for the conversion. Where available, the conversion of the freeze beneficiaries' growth shares to preferred shares with a fixed value (i.e. redemption amount equal to the FMV of the exchanged growth shares at the date of the conversion, which is typically nominal) will occur on a tax-deferred basis. In addition, the freezor can convert all of his or her freeze shares to new freeze shares with a redemption amount equal to the FMV of the freeze shares at the date of the conversion. Of course, the downside to utilizing a section 86 share reorganization versus a section 85 rollover is that a capital gain cannot be elected into where the FMV still exceeds ACB, and the LCGE may not be crystallized.

(c) Section 51 Share Conversion

As with the section 85 rollover and section 86 share reorganization, the basic mechanics of a section 51 share conversion have already been dealt with in section 2.4(c) of this chapter. In the context of an estate re-freeze, the common (growth) shares held by the freeze beneficiaries may be converted into non-participating, non-voting (i.e. fixed-value preferred) shares with a redemption amount equal to the FMV of the common shares at the date of the re-freeze; or the freeze shares held by the freezor may be converted into new freeze (participating) shares with a redemption amount equal to the FMV of the freeze shares at the date of the re-freeze. If a re-freeze was envisioned at the outset, then the shares so converted would likely already carry a conversion right pursuant to which the conversion could take place. A characterization of the conversion as a "disposition" should be avoided, unless the transaction is planned to take advantage of the LCGE.[44] A characterization of a shareholder benefit under subsection 15(1) must also be avoided.

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[43] In the landmark Supreme Court of Canada decision in *Army & Navy Department Stores Ltd.* v. *Minister of National Revenue*, [1953] 2 S.C.R. 496, it was held that the independent actions of a corporation are not considered to be the indirect actions of its shareholders. As a longstanding principle of corporate law affirms, a corporation has a separate legal existence from its shareholder(s).

[44] In this context, special consideration should be given to the anti-avoidance provision in subsection 110.6(8) of the *ITA*, which will deny the LCGE if it is reasonable to conclude that a significant part of the gain is attributable to

4. OTHER MEANS OF REVERSING OR ALTERING AN ESTATE FREEZE

Depending on the particular circumstances of the freezor and having regard for a host of other factors, a re-freeze may not always be the best option with respect to addressing a freeze previously executed. As such, there are a number of other permutations and combinations to estate freezes with similar nomenclature, such as melts, thaws, gels and reverse freezes. Each will be discussed in turn.

4.1 Melt

A "melt" is a term used to describe an arrangement where the freezor is able to access some of the appreciation of the corporation, not necessarily through growth shares, but by other means. Essentially, a melt allows some future value of the corporation to accrue to the freezor while leaving the legal structure of the initial freeze in-tact. There are various ways in which a freezor can retain the benefit of some of the future appreciation of the freeze corporation, namely by: increasing the salary or bonus paid to the freezor, the amount of dividends declared in favour of the freezor, management fees, or interest on any notes the freezor took back as part of the initial estate freeze; or through a share redemption.

(a) Salaries and Bonuses

In a typical estate freeze, the freezor, in addition to being a shareholder, will usually be a director, officer or employee of the freeze corporation; hence the "owner-manager" reference. The freeze corporation can pay the freezor a salary or bonus (or an increase thereof) for his or her services to the corporation, which must be included in computing the freezor's income for a taxation year in accordance with subsection 5(1) of the *Act*, insofar as the freezor is considered an "employee" of the freeze corporation. In a corresponding manner, the freeze corporation will be able to deduct such a payment as an expense of the business, subject to certain provisions of the *Act*.[45] Paragraph 18(1)(a) and section 67 of the *ITA* will affect the ability of the freeze corporation to deduct the remuneration that is so paid or increased under a melt. Pursuant to paragraph 18(1)(a), in computing the income of a taxpayer from a business or property, no deduction shall be made in respect of an outlay or expense except to the extent that it was made or incurred for the purpose of gaining or producing income from the business or property. According to section 67 of the *ITA*, no deduction shall be made in respect of an outlay or expense in computing income except to the extent that the outlay or expense was "reasonable in the circumstances".

Under current Canadian law, a corporation can deduct an unlimited amount of salary or bonus paid to an owner-manager on the basis that the corporation's profits are attributable to the owner-manager's work.[46] CRA administrative policy[47] with respect to the payment of bonuses and

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the fact that dividends were not paid on a share (other than a prescribed share as set out in Reg. 6205 of the *ITA*) of any class, or that dividends paid on such shares were insufficient.

[45] For example, subsection 78(4) of the *ITA* provides that a bonus declared by an employer corporation must be paid no later than 180 days after the taxation year in which the bonus was declared in order to be deductible by such corporation.

[46] See e.g. *Safety Boss Ltd.* v. *Canada*, [2000] 3 C.T.C. 2497 (T.C.C.) [*Safety Boss*]. Interestingly, remuneration in the form of bonuses paid to children might be warranted depending on the services rendered by the children, to the extent that they are reasonable: *Mépalex Inc. et al.* v. *The Queen*, 2002 DTC 1389 (T.C.C.) [*Mépalex*]. It

salaries is that it will not challenge the reasonableness of salaries and bonuses paid to principal shareholder/managers of a corporation when:

> …the general practice of the corporation is to distribute the profits of the company to its shareholder/managers in the form of bonuses or additional salaries; or the company has adopted a policy of declaring bonuses to the shareholders to remunerate them for the profits the company has earned that are attributable to special know-how, connections or entrepreneurial skills of the shareholders.[48]

CRA has also opined that such salaries and bonuses may go unchallenged where they are paid to managers who are shareholders of CCPCs (either directly or through a holding corporation), are Canadian residents, and are "actively involved in the day-to-day operations of the company."[49]

In the context of section 67, the courts have held that a deduction in respect of a bonus or salary will not be denied to the freeze corporation unless "no reasonable business person" would pay such amount.[50]

The concept of owner-manager remuneration is not new, and does not only arise in the context of an estate freeze or melt. For example, CCPCs have followed a traditional practice of paying salaries and bonuses to owner-managers in order to reduce their taxable income to or below the amount of the small business deduction ("SBD"). However, in view of the recent amendments to the dividend tax credit ("DTC") regime in Canada and the concept of "eligible dividends"[51], "bonusing down" to the SBD is no longer as commonplace as it previously was.

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has also recently been held that directors' fees paid to children are also deductible regardless of how little work is done, but they are subject to the reasonableness test in section 67 of the *ITA*: *Manchester Chivers & Associates Insurance Brokers Inc.* v. *Canada*, 2005 D.T.C. 1429 (T.C.C.) [*Manchester*]. On the other hand, whether CRA considers a bonus or management fee paid to a family trust as reasonable having regard for section 67 of the *ITA* is a "question of fact": CRA Document No. 2002-0141115, dated June 12, 2002 [*Doc No. 2002-0141115*].

47 It should be noted that while persuasive in nature and indicative of the way the Canada Revenue Agency ("CRA") will likely assess a taxpayer's circumstances, CRA administrative policies, such as Interpretation Bulletins, Information Circulars and Technical Interpretations, do not have the force of law, and must yield to the *ITA* and a court of law's interpretation of the *ITA*.

48 Adapted from "Revenue Canada Round Table", in *Report of the Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982); CRA Income Tax Technical News No. 22, dated January 11, 2002 [*IT Technical News No. 22*].

49 *Doc No. 2002-0141115*, *supra* note 46; see also "CCRA Round Table", in *Report of the Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004).

50 *Safety Boss, supra* note 46; *Manchester, supra* note 46 at ¶ 15; *Welton* v. *Canada*, [2005] T.C.J. No. 251 at ¶ 18.

51 "Eligible dividends" received by Canadian resident taxpayers enjoy preferential tax treatment. "Eligible dividends" are defined in subsection 89(1) of the ITA. Income that is available to be paid as "eligible dividends" is tracked in a notional account referred to as the General Rate Income Pool ("GRIP"). The GRIP tracks the corporation's income that was taxed at the general corporate rate (as opposed to the small business tax rate) at the end of the year, and will also include eligible dividend income received by the corporation. The amount included in the taxpayer's income is "grossed up" and the individual then receives a credit to offset the tax the corporation is presumed to have paid, resulting in less tax in an individual's hands. A CCPC can pay an eligible dividend only to the extent that it has GRIP at year-end, and a non-CCPC can pay an eligible dividend as long as it has no Low Rate Income Pool ("LRIP") at the time the dividend is paid. An eligible dividend received by a trust can be flowed out as such pursuant to subsection 104(19) of the ITA to a beneficiary.

Ultimately, care must be taken to ensure that the salary or bonus paid, or increase thereof, is reasonable in the circumstances and is paid for the purpose of earning income from a business (i.e. in respect of services provided by the owner-manager to the freeze corporation or for expertise). If viewed as merely a way of distributing the profits of the freeze corporation, then the entire characterization of the bonus or salary may be affected.

(b) Dividends

Another way to cause a melt is through the issuance of additional dividends to the freezor. Preferred shares (i.e., the freeze shares) in a freeze transaction will often have terms attached providing for the declaration of dividends up to a certain limit (e.g. as a percentage of the redemption amount of the freeze shares), or at the discretion of the director(s). Melting can have the effect of increasing the amount that is paid out to the freezor in the form of dividends. Note that, according to section 42 of the *CBCA*, a corporation will be restricted in its ability to declare and pay dividends if there are reasonable grounds for believing the corporation is or will be unable to pay its liabilities, or the realizable value of the corporation's assets would be less than the aggregate of its liabilities and stated capital. The same is provided by subsection 38(3) of the *OBCA*.

If improperly structured, a melt can result in adverse tax consequences for the freezor. For example, the freeze shares may provide for cumulative or non-cumulative dividends, or may be retractable non-dividend-bearing shares or shares with a fixed dividend entitlement; and the freezor may thus want to alter the attributes of the freeze shares by causing a reorganization of share capital pursuant to a section 86 rollover. However, as discussed below, a minor alteration of the share conditions that falls short of a reorganization may still be considered to be a "disposition" within the meaning of the *Act*[52] and a reacquisition, thereby triggering immediate tax consequences to the freezor.

In CRA Interpretation Bulletin IT-448 ("IT-448")[53], CRA generally discusses factors that are considered in determining whether or not a "disposition" has taken place for the purposes of the *Act*. In particular, CRA examines situations in which alterations of share conditions may be considered to be a disposition. In IT-448, CRA acknowledges that there are no "hard and fast" rules of universal application, and that it will examine the *effect* a particular set of changes seeks to achieve rather than the *method* used to accomplish those changes.[54] However, among those types of share changes that CRA regards as dispositions, it lists:

> (a) a change in voting rights attached to shares that effects a change in the voting control of the corporation;
>
> (b) a change in a defined entitlement (e.g. a change in par value) to share in the assets of a corporation upon dissolution (preferred shares only);
>
> (c) the giving up or the addition of a priority right to share in the distribution of assets of the corporation upon dissolution;

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[52] See subsection 248(1) of the *ITA* for the definition of "disposition" for income tax purposes.

[53] CRA Interpretation Bulletin IT-448, "Dispositions - Changes in Terms of Securities", dated June 6, 1980 [*IT-448*].

[54] *Ibid.,* at paras. 2 & 3.

> *(d) the addition or deletion of a right attaching to a class of share that provides for participation in dividend entitlements beyond a fixed preferential rate or amount;*
>
> *(e) a change from a cumulative to a non-cumulative right to dividends or vice versa.* [Emphasis added][55]

Curiously, among those changes that CRA enumerates as not being considered dispositions is: "…(i) an increase or decrease in the amount or rate of a fixed dividend entitlement."[56] It should be noted at this point that there have been several opposing views expressed in this regard; and it is, therefore, difficult to derive any sort of clear guidance as to what will or will not constitute a disposition in the eyes of the CRA.

Another possibility is to modify the provisions of the freeze shares by adding a conversion privilege so that the freeze shares could later be converted into shares bearing a higher dividend rate. This change, in and of itself, should not attract negative tax consequences as outlined above.[57] If the addition of a share conversion feature is viewed as increasing the value of the freeze shares, there is some speculation as to whether or not a shareholder benefit[58] will have been conferred on the freezor, or another anti-avoidance provision might apply to the freezor.

If there is a holding company structure in place, such dividends may be issued to the holding corporation on a tax-free basis.[59] As alluded to above, recent changes to the dividend regime in Canada has made the payment of certain types of dividends, called "eligible dividends", more tax-efficient than paying an owner-manager a salary or bonus in some circumstances.

(c) Share Redemption

Often, in exchange for his or her common shares in the corporation during the initial freeze, the freezor will have received preferred shares that are redeemable at the option of the freezor for an amount equal to the FMV of the shares at the date of the freeze, less any amount of debt and cash proceeds received on the transfer of assets to the freeze corporation.

The redemption of all or part of the shares will, however, cause a deemed dividend under subsection 84(3) of the *ITA* equal to the amount by which the redemption amount exceeds PUC, and a capital gain equal to the amount by which the redemption amount, minus the amount of any deemed dividends, exceeds the ACB of the shares. As is the case with dividends, the freeze

[55] *Ibid.,* at para. 14.

[56] *Ibid.,* at para. 15.

[57] *Ibid.,* at paras. 5 & 14.

[58] See e.g. subsection 15(1) of the *ITA*.

[59] This is insofar as the dividend does not exceed the "safe income" (income earned or realized after 1971) attributable to the shares owned by the corporate shareholder, the dividend will retain its tax-free character. Pursuant to the anti-avoidance provision in subsection 55(2) of the ITA, where a corporation has received a tax-free inter-corporate dividend as part of a transaction or series of transactions or events, one of the purposes of which was to cause a reduction in the capital gain that would have resulted from a disposition of the shares at fair market value, the dividend will not be received on a tax-free basis and will be deemed to be part of the proceeds of disposition, to the extent that the dividend cannot be attributable to income earned or realized by the corporation after 1971. Exceeding "safe income" by any amount will cause a re-characterization of the entire amount of the dividend.

corporation will be required to meet solvency tests, under subsection 36(2) of the *CBCA* and subsection 32(2) of the *OBCA*.

There are other possible ways to accomplish a melt, such as increasing the interest rate on promissory notes that the freezor has received in addition to the freeze shares as part of the consideration received during the estate freeze. Alternatively, the freezor may earn supplementary profits for providing management services to the freeze corporation through a management corporation owned by him or her. As is the case with any type of estate planning, melting involves nuances and complexities that are situation-specific.

The need for a melt during a recession may be questionable when the corporation's common shares may have depreciated, and as such, there may be reduced cash flow in the freeze corporation for a freezor to access. However, in conjunction with an estate re-freeze at a lower corporate value, a melt becomes a more sensible approach in future years when values regain momentum and are, once again, on the rise. In the alternative, a melt may now make sense in circumstances where the freezor has incurred unexpected losses and therefore requires the assets of the freeze corporation for his own purposes.

In any event, a melt is a convenient approach to temporarily soften an estate freeze while still maintaining the corporate structure put in place and respecting the freezor's intent in freezing the corporation in the first place.

4.2 Thaw

As its name so aptly suggests, a thaw is utilized to dissolve the effects of an estate freeze. In a thaw transaction, it is intended that the estate freeze is retroactively unwound, such that the freezor is put in virtually the same position that he or she was in before the estate freeze. Three methods of thawing an estate freeze will be canvassed: (a) reacquisition of growth shares by the freezor; (b) conversion of freeze shares into common shares; and (c) the use of a trust vehicle.

(a) <u>Reacquisition of Growth Shares</u>

In one method of using a thaw, the freeze beneficiaries could transfer the common (growth) shares of the freeze corporation acquired during the estate freeze back to the freezor. However, this may result in immediate capital gains being realized, to the extent that the proceeds of disposition of the common shares exceed their ACB. Eligibility for the LCGE (as discussed in detail above) will have to be considered.

The proceeds resulting from such a disposition between non-arm's length related parties[60] will have to occur for the FMV of the shares at the date of the disposition, since in accordance with subsection 69(1) of the *ITA*, where a taxpayer has disposed of anything to a person with whom the taxpayer is not dealing at arm's length for proceeds less than FMV, the taxpayer will be deemed to have received proceeds of disposition equal to the FMV of the property, and the transferee will be deemed to have received the property at its FMV. It has been widely acknowledged that valuing shares of a privately-held corporation can be exceptionally difficult.

[60] See subsection 251(1) of the *ITA* for a definition of "arm's length" and subsection 251(2) for a definition of "related persons".

It is therefore strongly suggested that a freezor obtain a valuation from a qualified expert, such as an independent valuator, in connection with thawing and estate freezing, in general. Improper or inaccurate valuation can leave such transactions vulnerable to scrutiny by CRA.

In this regard, a price adjustment clause can be a useful tool in an agreement pertaining to the purchase of the shares to avoid the application of the anti-avoidance rule in section 69 of the *Act*. It is a mechanism whereby the price agreed upon may subsequently be readjusted in the event that CRA has contested the value specified by the parties. CRA's Interpretation Bulletin IT-169 ("IT-169")[61] sets out the criteria that must be met in order for a price adjustment clause to be accepted. Among other things, the price adjustment clause must reflect a "*bona fide* intention of the parties to transfer the property at fair market value and arrives at that value for purposes of agreement by a fair and reasonable method."[62] To the extent that a price falls short of the FMV, as later determined, the shortfall must be accounted for.[63]

To the freezor, a thaw executed via a repurchase of the common growth shares may be ideal in a depressed economy where the value of the corporation has not risen substantially between the date of the initial freeze and the contemplated thaw, as the freezor would be able to reacquire the growth shares for a minor cost. At the same time, this will not be a unilateral event; and the consent of the freeze beneficiaries would have to be acquired, and a consensus with respect to the purchase price for the growth shares will have to be reached. Preferably, there will have been a shareholder's agreement in place from the outset, which could provide the manner in which the shares could be reacquired by the freezor (e.g. shotgun clause). In Information Circular IC 89-3 ("IC 89-3")[64], CRA has stated that an agreement, such as a buy-sell agreement, will be accepted as determinative of value between non-arm's length parties as long as: (1) the agreement is a *bona fide* business arrangement; (2) the purchase price in the agreement provides "full and adequate consideration, and represents the fair market value of the shares determined without reference to the agreement at the time it is executed"; and (3) it is a legal and binding agreement.[65]

(b) Conversion of Freeze Shares into Common Shares

Another way to effect a thaw is the conversion of convertible freeze shares into common shares of the freeze corporation. If a thaw was not envisaged at the date of the initial freeze, then the preferred shares obtained by the freezor during the freeze may have to be amended to attach a conversion right to such shares. Again, the issue of whether there has been a "disposition" in CRA's view will become relevant. If so, the arrangement may be regarded as having conferred a shareholder benefit on the freezor equal to the value of the conversion right so attached; and, pursuant to subsection 15(1) of the *ITA*, the freezor will be required to include such an amount (except to the extent that it is deemed by section 84 to be a dividend) in his or her income for the year.

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[61] CRA Interpretation Bulletin IT-169, "Price Adjustment Clauses", dated August 6, 1974 [*IT-169*].

[62] *Ibid.,* at para. 1; see also CRA Document No. 2005-0112321E5, dated April 11, 2005.

[63] *IT-169, ibid.,* at para. 1.

[64] CRA Information Circular IC 89-3, "Policy Statement on Business Equity Valuations", dated August 25, 1989 [*IC 89-3*].

[65] *Ibid.,* at para. 29.

If, on the other hand, a thaw was contemplated from the outset, then the freeze shares obtained by the freezor will have had a conversion right attached, and they can be converted into common shares. Such conversions often provide for a notice period and require the shareholder to be alive at the end of the notice period. It is generally accepted that no disposition is considered to have occurred where the conversion took place under section 51 of the *Act*. There may or may not be a triggering event creating an automatic conversion of the freeze shares. Another option is to have the conversion right and/or triggering event expressly provided for in a shareholder's agreement.

(c) <u>The Use of a Trust</u>

A further way of completing a thaw is through the use of a discretionary family trust (already discussed in detail in Section 2.4(d) of this chapter) on which the growth shares are settled. This method of thawing is also sometimes referred to as a "gel". Again, care must be taken to ensure that the attribution rules in section 74.3 and subsections 75(2), and 107(4.1) do not apply to the arrangement.

It has been suggested that, by virtue of the freezor's interest in the discretionary trust and possible position as trustee, the freezor has an interest worth more than a nominal amount, as may have been purported. This concern might be mitigated, however, by prescribing a nominal value only for the freezor in the discretionary trust. The freezor may also act as trustee with other independent trustees, and the freezor's discretionary interest should not have a more significant value than the other discretionary beneficiaries.

There is a bit of comfort in the fact that CRA has affirmed that the use of a discretionary trust for flexible estate freezing purposes will not necessarily trigger the application of the general anti-avoidance rule ("GAAR") in section 245 of the *ITA* (discussed below).[66] Nonetheless, this does not mean that other avoidance rules, such as those found in subsections 56(2) and 86(2) of the *Act*, are not applicable.

5. KEY CRA ADMINISTRATIVE POLICIES

CRA's administrative statements in respect of certain fact situations, where non-taxpayer-friendly, have been known to produce a chilling effect on estate and succession planning in those affected areas in the past. Estate re-freezing was one such area. As will be discussed below, it now appears that CRA's overall position with respect to re-freezing and the application of GAAR to such arrangements no longer leaves taxpayers contemplating these transactions out in the cold.

5.1 Estate Re-Freezing

CRA's longstanding policy with respect to estate re-freezing was that it conferred a shareholder benefit in circumstances where the freezor's freeze shares were exchanged for shares with a

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[66] See "Revenue Canada Round Table", in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991).

lower redemption or retraction value.[67] However in 1997, CRA warmed up to estate re-freezing and revised its former position.

Notably, in CRA Technical Interpretation 9607635, dated May 28, 1997, and Technical Interpretation 9229905, dated June 3, 1997, CRA indicated that as long as the decrease in the value of the shares causing the need for a re-freeze is not attributable to the "stripping of corporate assets", it will not ordinarily consider a benefit to have been conferred on the common shareholders or the freezor on the exchange of the freeze shares for new freeze shares having a FMV equal to the current FMV of the freeze shares. Of note however, CRA did not elaborate on the issue of what "stripping of corporate assets" meant.

More recently, in CRA Technical Interpretation 2000-0029115, dated November 17, 2000, CRA confirmed its statements in Technical Interpretations 9607635 and 9229905; namely, that there is no benefit conferred on the common shareholders in a re-freeze transaction provided the reduction in FMV of the preferred shares has not been caused by a stripping of the assets of the corporation and the FMV of the new preferred shares corresponds to the FMV of the preferred shares that would be covered by the re-freeze. This Ruling also gives taxpayers more guidance on what constitutes "stripping of corporate assets", since CRA viewed a payment of a dividend on another class of shares as being tantamount to "stripping" the corporate assets. CRA also reaffirmed its position in Technical Interpretation 2003-0046823, dated January 28, 2003, in the context of a reverse estate freeze.

5.2 General Anti-Avoidance Rule ("GAAR")

For the most part, it is acknowledged that estate freezing is a form of legitimate tax planning insulated from the effects of GAAR. In Information Circular IC 88-2 ("IC 88-2")[68], CRA offers guidance with respect to the general applicability of GAAR. In particular, at paragraph 10 of IC 88-2, CRA states that estate freezes "would not ordinarily result in misuse or abuse given the scheme of the Act" and having regard for the specific attribution rules found in section 74.4 of the *Act*. Shortly thereafter, in the context of an estate freeze in favour of a discretionary trust where the freezor was also a discretionary beneficiary, while CRA declined to state definitively, whether this would always be acceptable, it found that the facts, in and of themselves, would not generally result in the application of the GAAR.[69] Subsequently, in 2002, in response to the question of whether there were any business transactions that were "really safe" from GAAR, the CRA listed estate freezing as an area where GAAR has been found not to apply.[70] This, of course, must not be taken to be a blanket endorsement of all estate freezing transactions.

On the other hand, consideration by CRA of the application of GAAR to re-freezing transactions has been sparse. Technical Interpretation 2000-0050983, dated in 2001, considers the

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[67] See e.g. "Revenue Canada Round Table", in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 49:1-32, question 53; CRA Document No. 9M19020, dated October 10, 1997, "Federal Round Table on Taxation," 1997 APFF Conference, question 2.5.

[68] CRA Information Circular IC 88-2, "General Anti-Avoidance Rule - Section 245 of the I.T.", dated October 21, 1988.

[69] "Revenue Canada Round Table," in *Report of the Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991) 50:1-68, question 20.

[70] *IT Technical News No. 22*, *supra* note 48 at question 7.

application of GAAR in a re-freeze transaction. This Technical Interpretation involves a convoluted set of facts; however, CRA ultimately found that GAAR did not apply to the re-freeze in question. Because there has been so little examination of GAAR in respect of estate re-freezing it is doubtful that any meaningful principles can be derived and applied to estate planning going forward. Nonetheless, given the anticipated increase in popularity of re-freezing in today's challenging times, we will likely hear a lot more from the taxing authorities on the issue of whether GAAR will apply to estate re-freezing as taxpayers attempt to obtain CRA's blessing on such transactions.

6. CASE LAW AFFECTING ESTATE FREEZING AND RE-FREEZING

No chapter on estate freezing and re-freezing would be complete without a discussion of the recent jurisprudence that has developed in the area, as this inevitably shapes the manner in which estate planning is conducted going forward. Many of the cases that will be discussed below examine the issue of what happens when an estate freeze goes wrong, and the solutions that may be employed to remedy them, such as rectification. There are also several family law cases which consider whether or not shares owned following an estate freeze should form part of net family property ("NFP") for the purposes of dividing property upon marital breakdown.

Given that a freezor's pool of wealth may have shrunk considerably as a result of the recession, it would be ill-advised to ignore the current case law in the area of estate freezing and re-freezing.

6.1 Family Law Cases

As a general principle, any assets gained during marriage are equally divided between spouses on the dissolution of the marriage. However, there are some exceptions to this rule. For instance, a gift or inheritance received after the date of marriage is excluded from the calculation of NFP, but the income from such a gift may be included if not specifically excluded by the donor. Whether or not assets received as a part of an estate freeze are included in a calculation of net family property under family law is an issue that has not been heavily considered by the courts, however a few decisions have provided some guidance.

A foundational case in this area was *Black* v. *Black*[71]. In that case, the husband had received shares in a business as a part of an estate freeze by his father. The transaction had been carefully structured as a purchase to avoid gift tax under the *Gift Tax Act*. On the breakdown of his marriage, when calculating the division of property, the husband argued that the shares should be excluded from the calculation since they were a gift. The court rejected this position, holding that the husband could not consider the shares a purchase for tax purposes and a gift for family law purposes. Therefore they were included in the assets to the divided.

In *Armstrong* v. *Armstrong*[72] the husband had acquired during the marriage a contingent interest in a family trust. The trust was created as a part of an estate freeze. The husband had given no consideration for his inclusion in the trust, which had a provision specifically excluding any gift or benefit in favour of any beneficiary of the trust from the net family property of the beneficiary

[71] (1988), 66 O.R. (2d) 643 (S.C.) [*Black*].

[72] [1997] O.J. No. 4137 [*Armstrong*].

for the purposes of the *Family Law Act*. Therefore, the interest in the trust was considered to be a gift from the father and was not included in the calculation of net family property.

Dalgleish v. *Dalgleish*[73] also involved a husband who had received assets during the marriage as a result of his father's estate freeze. In this case, as in *Black*, the estate freeze had been structured such that that husband had given consideration for the shares. However, the husband's father testified to the effect that he had in fact paid his son's subscription price for the shares and accordingly, there was no actual consideration and the shares were a gift. The court rejected this reasoning, citing the precedent in *Black* that since they were structured to be a purchase, they were considered so for family law purposes. Therefore his shares were included in the calculation of the net family property.

This decision has been the subject of some criticism. It has been pointed out that since the *Gift Tax Act* is no longer in force, there is no longer the same rationale for considering the transfer of stocks to not be a gift. Nevertheless, given the courts' perspective on this matter, if an estate freeze can be structured as a gift, it would be to the benefit of the children or other recipients of the property that it be done so. Perhaps even more importantly, marital contracts should be considered where important corporate assets or shares are owned or likely to be owned in the future by one of the spouses, in order to ensure that they will not be included in the division of family assets should the marriage fail.

6.2 Rectification: What to do When the Execution of an Estate Freeze does not Reflect the True Intention of the Parties

Rectification is an equitable doctrine which allows a court to amend an agreement that does not reflect the actual intentions of the parties. It is meant to apply to a situation in which there was a genuine meeting of the minds of the parties involved, but there was an error in the legal instruments, which has the effect of altering the original intention of the parties. When an order for rectification is granted, a court will allow for the correction of the impugned agreement and enforce the agreement as amended.

In the tax context, rectification is usually sought as a remedy where a mistake in legal instruments gives rise to adverse tax consequences. However, caution must be used when seeking this remedy, as parties will not be successful where it is regarded as an invitation for the court to engage in retroactive tax planning to enable parties to obtain more favourable tax treatment.

Rectification becomes an important device in the context of estate planning where there has been an improperly executed estate freeze. *Attorney General of Canada* v. *Juliar* ("*Juliar*")[74] is a landmark Ontario Court of Appeal decision considering the doctrine of rectification in the context of an estate freeze. It involved a section 85 rollover where the disposition of shares that would otherwise occur on a tax-free basis was viewed as a disposition of property giving rise to immediate tax liability under section 84.1 of the *ITA*, and resulting in a deemed dividend. On the rollover, the parties took back promissory notes instead of shares based on incorrect information

[73] 2003 CarswellOnt 2758 [*Dalgleish*].

[74] [2000] O.J. No. 3706 (C.A.) [*Juliar*].

from their advisors. The Minister of National Revenue (the "Minister") reassessed, resulting in additional tax liability for the parties of over $100,000.

The Ontario Court of Appeal, per Austin J.A., upheld the trial decision and allowed the rectification. The Court of Appeal agreed with the trial judge that the true intention of the parties was to execute an estate freeze without attracting immediate tax liability, and that the only reason that this had not been done was because of a misapprehension. The Court also found that there was evidence that the transaction would never have been entered into if it could not have been done on a tax-deferred basis. *Juliar* is significant because it is said to represent the high-water mark with respect to intention, or embody the "modern principle of intention" whereby parties may have intended to arrange their affairs "on a basis which would not attract immediate liability for income tax on the transaction."[75]

Di Battista v. *874687 Ontario Inc.* ("*Di Battista*")[76] is a recent Ontario Superior Court of Justice case that also considered the rectification of three share purchase agreements in the context of an estate freeze. The freeze was executed improperly such that it frustrated the intentions of the parties and gave rise to unintended immediate tax liability. The facts in *Di Battista* are not set out in detail in the decision. However, *Di Battista* is significant because it affirms the principle expounded in *Juliar*, namely that if the Court is satisfied that the true agreement between the parties, which can be based on not attracting or minimizing tax liability, is frustrated, rectification may be permitted to reflect the transaction as intended.

In sum, an important principle that can be drawn from these cases is that, assuming the other criteria for rectification are met, the intention of the parties to avoid immediate tax liability is a valid intention that may justify the equitable doctrine of rectification. It is not unusual that many of the rectification cases involve estate freezing, since reorganization in the estate planning area can be extremely cumbersome and complicated. It is, however, a bit of a reassurance to know that there is a remedy available to counteract the negative tax implications of an improperly executed estate freeze or subsequent modification. Where a rectification order is sought, CRA must be informed[77] and the Department of Justice's Rectification Committee, established after the *Juliar* decision, will review the rectification application. Where CRA does not oppose the rectification application, it will often issue a comfort letter to an applicant, which has informally been suggested to be required by Courts in cases where a tax issue is raised.

7. CONCLUSION

The authors trust that this chapter has given the reader a good overview of the relevant rules, concepts and issues involved in estate freezing, re-freezing or otherwise modifying an existing estate freeze. It should be noted that this chapter is not intended, in any way, to be a substitution for proper and sound legal advice with respect to estate and succession planning. It is therefore recommended that professional tax advice be sought when considering an estate freeze, re-freeze, reverse freeze, melt, thaw, etc.

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[75] *Ibid.,* at ¶ 19.

[76] [2006] 5 C.T.C. 152 (Ont. S.C.J.) [*Di Battista*].

[77] *Re Columbia North Realty Company* (2005), 60 D.T.C. 6124 (N.S.S.C.).

Overall, the authors have hoped to convey the idea that a depressed economy need not cause the reader's spirits to dip below zero as well. This is especially true in light of the myriad of tax opportunities available to take advantage of a recession and weather the storm. For many individuals, the legal costs associated with estate planning may seem like an additional strain, particularly in challenging markets. But these initial costs may be far outweighed by the ensuing savings, and should not, therefore, put estate and succession planning "on ice".