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TAX STRATEGY

A key strategy if your business already has an estate freeze in place

The refreeze

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Last month I talked about how the current economy offers tax planning opportunities in the form of a measure that lets you defer the tax liability of growing assets as a financial planning strategy.

Specifically, lowering your eventual death tax bill by implementing an "estate freeze."

As I said in June's *TaxLetter*, low market values offer the temptation to transfer assets of a business into a corporation ("Opco" or "operating company") and freezing your value in Opco for the benefit of the next generation.

What I haven't touched on is was what you can do now if you already implemented an estate freeze years ago.

Perhaps, you find yourself in a position where the value of Opco has decreased so much that the freeze value in place when you implemented the estate freeze is now, on paper at least, worth more than the entire value of Opco.

This is the situation that some of my clients have found themselves in, especially those clients whose assets include a lot of real estate. I will tell you what I tell them — let's "refreeze."

What is a refreeze?

An estate freeze contemplates freezing your value in Opco at the current value at that time, so that any future growth in Opco will be diverted to the next generation (usually by way of a discretionary family trust).

A re-freeze is exactly what it sounds like: implementing a new estate freeze in Opco to freeze your value in Opco at the current (and lower) value. The process is relatively simple. Let's assume you took advantage of an estate freeze 10 years ago and you currently hold preferred shares of Opco that were frozen at that time at, say, $3 million.

Let's also assume you gave new growth shares in Opco to a discretionary family trust. Now, 10 years later, you find that Opco's value in total is only $2 million.

You can simply reorganize the share capital of Opco so that your $3 million in preferred shares are exchanged for new preferred shares equal to the current $2 million value.

New growth shares would be given to the family trust (or a new trust). Now you have lowered the value of your preferred shares, which in turn means lower death tax upon your passing. Of course it is to be hoped that Opco will grow in value once the recession is over and all future growth will pass to the family trust (i.e. the next generation).

In turn, you have effectively limited the capital gains tax your estate will have to pay on your death by reducing your assets by $1 million.

Other benefits of a refreeze

Limiting your death tax bill is only one of the benefits you'll get when you implement a refreeze.

Without a refreeze, you

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could be jeopardizing the ability to sprinkle income to certain family members. Alternatively, with a refreeze you may be able to take advantage of extending the tax-life of a family trust, or better protect the family assets from any potential claims by an ex-spouse.

Income splitting

One of the benefits of an estate freeze is to allow for income splitting with other low-income family members by distributing income through dividends to the next generation (subject to the attribution rules which prevent income splitting with minors or a spouse).

If, however, the value of Opco has been reduced to below the value of your freeze shares, then declaring dividends may be limited under corporate law – i.e. the constating, or originating, documents for Opco would usually provide that dividends cannot be paid if there is insufficient value in Opco to satisfy the value of the freeze shares.

Accordingly, by refreezing, you are lowering the value of the shares, and thereby enhancing the ability to continue to split the income by declaring dividends on the growth of the shares for the next generation.

Extending the life of a trust

You may be aware that a discretionary family trust will be subject to the "21 year rule." Essentially, on the 21st anniversary of a trust, CanRev will treat the trust as having a deemed disposition.

That is, the trust will be deemed to have sold all of its assets and reacquired those same assets at their fair market value. This translates to a capital gains tax bill to the trust.

Therefore, tax and trust practitioners always advise that you should take steps to distribute the assets out of the trust prior to the 21st anniversary to avoid this deemed capital gain.

The good news is that the assets can be distributed to the beneficiaries on a tax-deferred basis as a general rule, assuming that the beneficiaries are Canadian residents (and assuming the trust has not been tainted by other tax issues – speak to your tax advisor to ensure the trust has not tripped into any of these rules).

Remember, 21 years may seem like a long time from now, but the time may pass quicker than most of us would like to think. Now let's go back to my initial example where you had frozen Opco 10 years ago and are considering a refreeze for the reasons I have already mentioned.

Rather than giving the new growth shares to the existing trust, which is already 10 years into those fateful 21 years, you can create a new family trust and issue new growth shares to the new trust. Thus you "reset the clock" on the 21 years.

So rather than having to distribute the shares of Opco from the old trust within 11 years, you can now sit back for another 21 years before you have to think about any such distribution.

Family law

A non-tax reason for refreezing relates to protecting the family business from marital claims on the breakdown of your son or daughter's marriage.

Under Ontario family law, gifts after marriage will be excluded from marital claims for the division of property if the proper language is included in the gift.

If your children are not married at the time of the original estate freeze, your kids' interest in Opco (owned directly or through a discretionary family trust) could be subject to a marital claim.

Accordingly, if your kids subsequently get married, you may want to consider refreezing, and gifting new growth shares to your kids (or to the trust of which they are beneficiaries).

In this manner, the new growth shares would be considered a gift after marriage and could potentially be excluded from any claims by their spouse upon a marriage breakdown.

If you are looking at Opco's balance sheet, and not liking what you see, you should consider speaking to your tax advisor about refreezing so that you at least able to glean some small advantage from this down economy.

And, if you decide to refreeze, make sure you've considered all the possible options, so your assets are preserved in the best possible condition. ❒