REFREEZES*

By: David Louis, J.D., C.A., Tax Partner
Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

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In some cases, where an estate freeze has been implemented, it many turn out that the value of the frozen corporation has since depreciated. (At time of writing, this is a very realistic scenario for relatively recently-implemented freezes.) Under these circumstances, it could obviously be beneficial to undertake a new freeze at a lower value. In the standard freeze configuration, Freezor's freeze shares would be exchanged for shares with a lower redemption/retraction value.

For many years, the CRA's position was that, if this was done, a benefit would arise. Although this position was debatable (and some practitioners had devised schemes designed to reduce the possibility of a reassessment on this basis), the spectre of reassessment was enough to scare off many taxpayers from undertaking a refreeze.

However, in the spring of 1997, the CRA reconsidered this position, as confirmed by Technical Interpretations No. 9229905, dated June 3, 1997, No. 9607635, dated May 28, 1997 and 2000-0029115, dated November 17, 2000[1]. These interpretations indicate that the CRA's is now of the view that a benefit would generally not be considered to have occurred unless the decrease in value is the result of stripping of corporate assets.[2] In most instances, therefore, the ability to refreeze at a lower value is now open[3].

Besides the obvious benefit of lowering exposure to death tax, a refreeze can have a number of other important advantages:

- **Reset the "21-year clock".** It is usually advisable to distribute appreciated assets from a family trust prior to its 21st anniversary. Since the value of the common shares would presumably be nominal, it is therefore possible for the growth shares to be held by a new family trust, so as to restart the 21-year period, and thus prolong the "protective environment" of the trust.

- **Restore Income splitting.** As observed in Chapter 2, a properly-executed freeze will include a "non-impairment clause" that prevents the payment of dividends on common shares if the effect would be to impair the ability to redeem the freeze shares. Thus, if the value of the freeze shares is "under water", the ability to pay dividends will be blocked. Thus, a refreeze will "unlock" the ability to dividend split.

- **Tax discounts.** If an asset freeze has been effected, i.e., through the transfer of assets into the frozen corporation in return for freeze shares, the CRA's policy is that there should be no discount for the deferred tax exposure on the assets themselves (see ¶211 for further discussion). A refreeze should enable a tax discount to be taken in respect of the redemption amount of the freeze shares.

- **Ability to revise and correct matters pertaining to family trust.** A new trust will allow changes to be made to the trust relative to the preceding trust. For one thing, the terms of the trust can be "modernized" in view of recent estate planning developments, or revised to take into account changing circumstances. One example is if a beneficiary has become or is likely to become non-resident. In this case, a corporate beneficiary can be provided for, in order to alleviate the deemed disposition that would otherwise apply pursuant to subsection 107(5) (see ¶317 for further discussion). It may also be possible to address issues relating to associated corporations.

  Alas, a more compelling reason for the revision of trust provisions may arise if there have been technical deficiencies in the previous trust. A notable example of this is the application of "reversionary trust" attribution rules in subsection 75(2). As noted in Chapter 2, if subsection 75(2) has *ever* applied in respect of property transferred to a trust the tax-deferred rollout of trust property may be denied under subsection 107(4.1) other than to the transferor and his or her spouse[4]. Apart from this problem arising from drafting deficiencies, subsection 75(2) may also apply because of transactions with the trust. For example, if property is transferred to a trust by a beneficiary, subsection 75(2) may apply, since the property could revert to the beneficiary. This could even be problematic where a beneficiary pays a bill rendered to the trust by a professional advisor or other trust expenses. A transfer could include a purchase and sale, even if at fair market value, but is not considered to include a genuine loan.

Thus a refreeze – i.e., when the shares held by a family trust are worthless – may be a golden opportunity to rectify old “errors and evils”.

- **Family law.** A refreeze may enable improvement to the family law situation. In Ontario, for example, if a freeze is undertaken prior to the marriage of the beneficiary, the interest in the family trust as well as distribution of growth shares therefrom may be subject to a division of property. However, if the refreeze is effected after marriage, it can be asserted that the beneficiary’s interest constitutes a gift after marriage and is therefore exempt from a division of property. The lower freeze value may also reduce exposure to a division of property *vis-à-vis* Freezor.
- **Establishing a lower “presumptive value”.** If the value of the corporation remains below the original freeze value when the deemed disposition on death occurs, the lower value should prevail – in theory. However, establishing this with the CRA could be an uphill battle, since the actual value at death will be “open-ended”; it might even be presumed that the original redemption/retraction amount should prevail. Refreezing resets the “presumptive value” on which tax will be based – i.e., at the lower redemption/retraction amount.

Of course, the lower freeze value will reduce Freezor’s assets; accordingly, Freezor should be comfortable with the lower freeze value. If not, alternatives include a partial freeze or implementing a “gel” structure, as discussed at ¶904; however, in the latter case, the implications of fiduciary duties of the trustees in respect of a “bail-out” to Freezor should be considered.

David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. David’s practice focuses on tax and estate planning for entrepreneurs and their corporations. *Tax and Family Business Succession Planning* (2nd edition) was recently honoured by being selected by the Financial Post Magazine as a recommended resource for the “Entrepreneur’s Toolkit” as part of their feature on succession planning (*Financial Post Magazine*, May 2009).

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[1] See also Question 2.5 of the 1977 APFF Round Table (Doc. No. 9M19020, October 10, 1997). The first document envisions that “the common shares of the ‘freeze’ corporation are sold, at FMV, to either the holder of the preferred shares or the ‘freeze’ corporation, thereby resulting in only one shareholder, and new common shares are then issued to the former common shareholders”. Similar methodology had been suggested as a method of coping with the CRA’s former views that a refreeze could result in a benefit.

[2] It is not completely clear what the CRA has in mind in respect of the stripping of corporate assets. If this were done by distributions on the freeze shares themselves, this would either trigger tax on dividends, if received by the Freezor, or if received by Freezor’s holding company (i.e., so that the dividend is tax free), an increase in the corporation’s value, and therefore a corresponding increase in death tax exposure to the Freezor. One would think that either result would not be offensive. It appears that the CRA is more concerned with distributions in respect of the growth or other shares – see Doc. No. 2000-0029115. However, it is standard practice to insert a specific prohibition on such distributions, if they would impair the value of the freeze shares (i.e., in addition to prohibitions that may exist in corporate statutes) in view of the CRA’s standard ruling requirement that the corporation should not be permitted to pay dividends on other shares in an amount that would reduce the fair market value of the preferred shares below their redemption price, or that would result in the corporation not having the necessary net assets for the redemption of the outstanding freeze shares. A reduction in the corporation’s value could also be caused by large bonus payments, e.g., in connection with a post-freeze asset sale by the corporation. Given that the effect of this would be to eliminate the deferral from lower corporate tax rates and more or less prepay the additional death tax that would arise from retaining profits at the corporate level, query whether this should be offensive to the CRA.

[3] For example, Doc. No. 2000-0029115 indicates that, provided the decrease in value of the preferred shares in refreeze transactions is not the result of the stripping of corporate assets, the CRA does not ordinarily consider a benefit to have been conferred on the common shareholders or the preferred shareholder on the *exchange* by the preferred shareholder of his or her original shares for *new preferred shares having a fair* *market value equal to the present fair market value of the original preferred shares*. Note that this answer envisions new preferred shares having a value equal to the value of the old preferred shares, rather than a value somewhere between the new value and the original value.

As discussed at ¶225, the taxable and short-term preferred share rules may sometimes be problematic, particularly in respect of *post-mortem* planning, e.g., where the “related exception” does not apply because control of a frozen corporation does not pass to the executors. The subsection 191(4) exclusion will not apply (by virtue of paragraph 191(4)(d)) on a deemed dividend on the redemption of preferred shares that were issued for consideration consisting of taxable preferred shares. This situation may occur in a refreeze.

[4] While the transferor is still alive.