

# The TaxLetter®

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Your Guide to Tax-Saving Strategies

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## TAXMATTERS

### *Family Business Succession Planning II:*

# The refreeze

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Last month I discussed how estate freezes were a good planning tool for family-owned businesses. One point I did not mention was that estate freezes are also a good strategy if your business had gone down in value, or is currently experiencing a dip, since you can freeze your interest in the operating business (“Opco”) at a lower value, creating a lower tax bill on your death. But what if your business is in a low swing right now, but you had already implemented an estate freeze years ago, when values were higher? On paper, your freeze value in Opco is worth more than the entire value of Opco. The solution? Refreeze.

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#### **What is a Refreeze?**

As I discussed in last month’s article, an estate freeze contemplates freezing your value in an Opco at the current value at that time, such that any future growth in Opco would be diverted to the next generation (usually by way of a discretionary family trust). A refreeze is exactly what you think it sounds like: implementing a new estate freezes your value in Opco at the current (and lower) value.

The process is relatively simple. Assuming you implemented an estate freeze 10 years ago, you currently hold preferred shares of Opco that were frozen at the value of Opco at that time, let’s say \$5 million. Let’s assume you gave new growth shares in Opco to a discretionary family trust. Now, 10 years later, you find that Opco’s value in total is only worth \$4 million.

We would simply reorganize the share capital of Opco so that your \$5 million preferred shares are exchanged for new preferred shares equal to the current \$4 million value. New growth shares would be given to the family trust (or a new trust – see discussion below).

We have now lowered the value of your preferred shares, which in turn means lower death tax upon your passing. Of course it’s hopeful that Opco will now grow in value once the recession is over and all future growth will pass to the family trust (i.e. the next generation). So you have effectively limited the capital gains tax that your estate will have to pay on your death by decreasing your assets by \$1 million.

#### **Other benefits of a refreeze**

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

#### **Income splitting**

As discussed last month, one of the benefits of an estate freeze is to allow for income splitting with other low-income family members (subject to the attribution rules which prevent income

splitting with minors or a spouse) by sprinkling income by way of dividends to the next generation. If, however, the value of Opco has been reduced to below the value of your freeze value, then the ability to declare dividends may be limited under corporate law – i.e. the contacting 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 freeze shares, and thereby enhancing the ability to continue to income split by declaring dividends on the growth shares for the next generation.

### **Extending the life of a trust**

As you may be aware, a discretionary family trust will be subject to the “21 year rule”. Essentially, on the 21st anniversary of a trust, Carve will treat the trust as having a deemed disposition i.e. the trust will be deemed to have sold all of its assets and reacquired those assets at the fair market value, which translates to a capital gains tax bill to the trust.

To avoid this deemed capital gain, tax and trust practi-

tioners always advise that you should take steps to distribute the assets out of the trust prior to the 21st anniversary. The good news is that the assets can be distributed to the beneficiaries on a tax-deferred basis as a general rule, assuming that the beneficiaries are Canadian residents (and assuming the trust has not been tainted by other tax issues – speak to your advisor to ensure the Trust has not tripped in any of these rules). However, despite what you may initially think, 21 years sometimes passes quicker than you may like.

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

### **Family Law**

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

If this strategy hits close to home for you, then I would caution you to discuss this type of restructuring with a family lawyer. This will ensure that you are properly protected, as family courts are known to be “courts of equity”, meaning that a properly implemented refreeze may be seen as unfair to the new spouse. □