

IN THIS ISSUE

- 1 The Death Tax Time Bomb
- 2 Estate Freezes – The Whys and Wherefores
- 5 Reviewing Estate Freezes – Opportunities and Traps
- 6 Firm News and Professional Notes

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A CLIENT OVERVIEW OF LEGAL TRENDS AND ISSUES

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The Death Tax Time Bomb

Nearly thirty years ago, the government replaced estate taxes – basically taxes on *wealth* – with a death tax system designed to tax asset *appreciation*. In general, tax rules impose a “deemed sale” at then-current market values when assets pass upon death.

Because these death taxes could be deferred when assets pass to a spouse,¹ the rules did not do much damage because, for many years, there was usually a surviving spouse. But in the next few years, “Grim Reaper” will acquire a new meaning; the government is set to collect untold amounts of taxes, as hitherto surviving spouses pass away and assets start to pass between

generations. It’s no wonder that estate planning has become a hot topic. The next two editions of our newsletter will be devoted to recent developments in estate planning. In this issue we will focus on estate freezes. In the next edition, we will focus on wills and probate planning, and the little-understood area of *post mortem* estate planning.



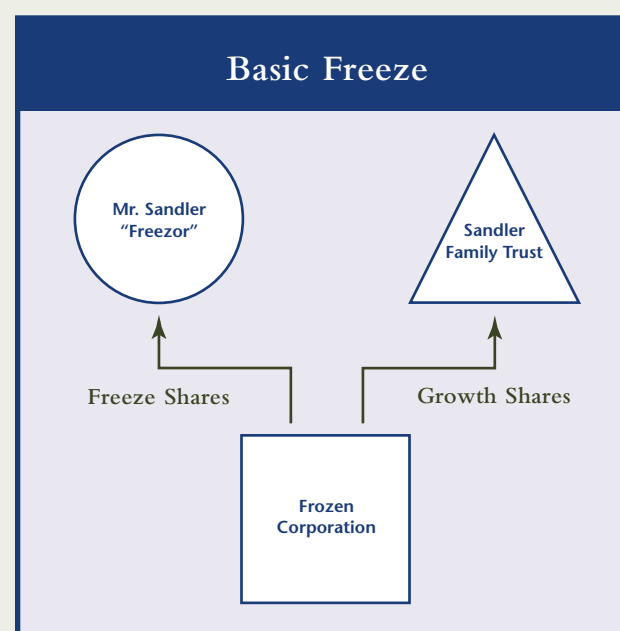
Estate Freezes – The Why's And Wherefores

Joan E. Jung and Daniel Sandler

An estate freeze refers to the sequestering of future growth in value of a business or investment in the hands of a subsequent generation – “children.” This limits capital gains and other tax exposure that normally occurs when assets pass from parents to children, either during their lifetime or on death.

To avoid the “deemed sale” rules mentioned earlier, the most common form of estate freeze involves the transfer of assets to a corporation with a freeze configuration (the “Frozen Corporation” – see diagram below) or the reorganization of an existing corporation into such a configuration. This is typically combined with a family trust. The parent(s) receive shares that are configured in such a manner so that their future growth in value is eliminated or limited (“Freeze Shares”) and enable the parent(s) to retain control. The future growth accrues instead to the trust (which holds the “Growth Shares”).² Although the Growth Shares could be held directly by children (often the case with older freezes or where the freeze is in favour of adult children), the

family trust can be put in place to afford an additional degree of control and protection against mismanagement by the children, who become



beneficiaries of the trust. In most cases, a “discretionary trust” is used, which, in effect, enables the trustees to determine “who gets what and when.”

An estate freeze should be implemented where the underlying assets are not intended to be sold during the parents’ lifetime. So most freezes involve family businesses or long-term real estate holdings. There’s no point, for example, in freezing shares that are subject to a mandatory buy/sell on death, nor is it usually advisable to freeze investments which are likely to be “tax paid” on death, for example, portfolio shareholdings which are likely to be sold during the parents’ lifetime, most mutual funds, or interest-bearing investments.³ In fact, transferring these into a corporation often leads to tax and other complications. Nor may a freeze be advisable if the freezer’s children are very young. The reason is that, where a family trust is used to hold the Growth Shares, to avoid capital gains tax, the shares must be distributed to the beneficiaries prior to the 21st anniversary of the trust. However, where future growth is likely to be high, certain counter-strategies may deal with the “21-year rule.”

As we mentioned, the effect of an estate freeze is to leave the parent(s) with Freeze Shares, where the future growth is capped (or limited). The bad news is that traditional freezes leave a parent with shares with a value fixed at the time of the freeze, leaving the freezer not only with a set capital gains tax exposure, but with exposure to creditors and matrimonial claims. Happily, innovative strategies can be used to reduce exposure on all three fronts, often enhancing tax-deferral benefits.

Periodic Review

If you have already done an estate freeze, the structure should be reviewed from time to time. Here are some areas that may be addressed:

- **21-year planning.** The most important time to review an estate freeze is preceding its 21st anniversary. As we mentioned earlier, if assets are not distributed from the trust prior to this anniversary, capital gains or other tax exposure may arise in the

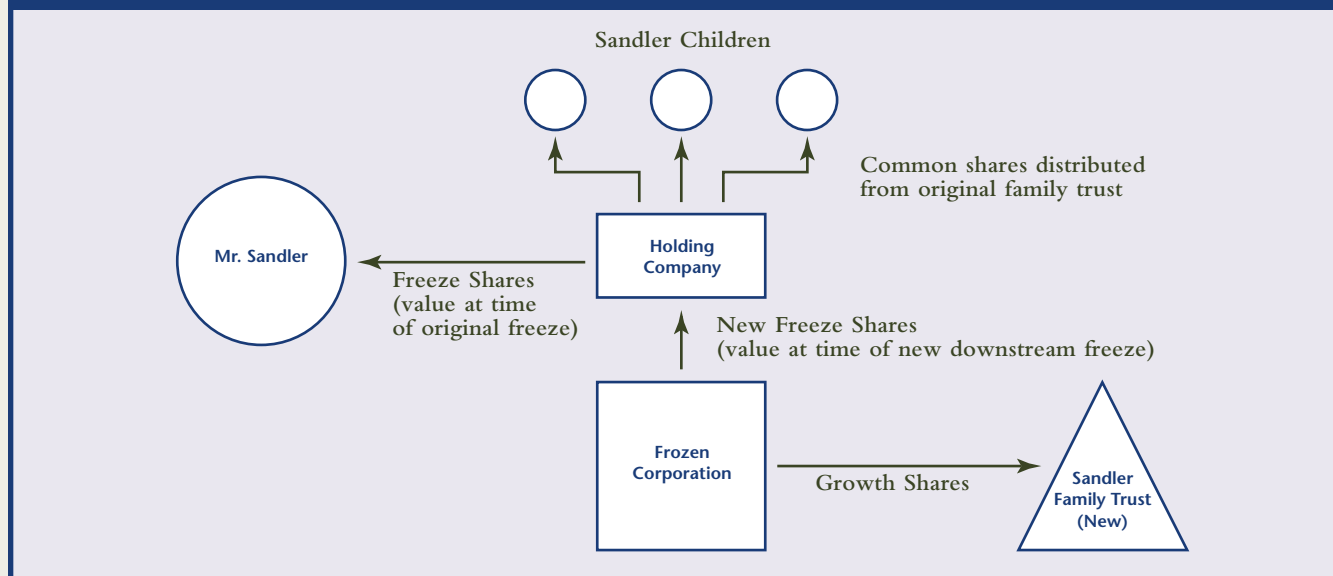
trust, as tax rules call for a deemed sale on assets that are held by the trust at this point. In addition, owing to fairly recent tax changes, trustees are now jointly and severally liable for taxes incurred by the trust as a result of missing the 21-year deadline.⁴ So trusts set up in the early ‘80s should now be reviewed.

We suggest that this review occur at least a year before the 21st anniversary. For one thing, if the trust is discretionary, it will be advisable for the trustees to determine the details of the distribution; for another, the 21st anniversary of a trust may be the occasion for new estate planning initiatives, for example, a new freeze in favour of grandchildren rather than children. One interesting way to achieve the latter is what we call a “downstream freeze.” This refers to a freeze that is effected by a reorganization of a subsidiary or other “downstream” corporation – i.e., “below” the top corporation where a conventional freeze occurs. The diagram below illustrates what a downstream freeze might look like. You will note that the new Freeze Shares – which are normally redeemable at the option of the holder (“retractable”) – are not directly held at the personal level, allowing for increased flexibility to cope with valuation issues; as well, such a redemption is controlled by the freezer as the controlling shareholder of Holdco rather than the children. Another advantage of a downstream freeze, especially in situations where a freeze has previously been done, is that it may facilitate a distribution of the new growth shares out of the new trust which differs from the distribution out of the original family trust.⁵ Of course, the parent will continue to have voting control.

- **Changes in tax laws.** Tax laws are in a constant state of flux. One notable example is the life insurance area, particularly the advantages of corporate-owned life insurance, which can not only *fund* death tax liability, but, if properly structured, can actually *reduce* it.

Some years ago, it was possible to obtain a dollar-for-dollar reduction of capital gains tax on death with corporate-owned insurance.⁶ In April of 1995, these rules were changed, but with “grandfathering” for

Downstream Freeze



certain pre-existing arrangements. (Note: these arrangements should be reviewed carefully, e.g., in order to ensure that grandfathering status continues to apply.) After this, the general rule was that corporate-owned insurance arrangements would only result in a 25% reduction in capital gains death tax exposure. But as a by-product of last year's changes to the capital gains inclusion rate, the death-tax reduction for structured corporate-owned insurance arrangements can increase back up to 50%. This means that, with capital gains tax itself at less than 25%, a well-structured corporate-owned insurance arrangement can cut the death tax to the 12% range. (Besides grandfathered insurance arrangements,⁷ one instance in which a dollar-for-dollar death tax reduction may still be available is when a buy-sell agreement is structured so that shares nonetheless pass to a surviving spouse, e.g., using a structure where holding companies enter into the buy-sell.)

- **Investment income.** Another overlooked tax planning opportunity relates to the build-up of investment income by companies. This income can result in special corporate "surplus accounts" (notably capital dividend or refundable dividend tax on hand accounts) that can be used to reduce the death tax exposure to

parents holding Freeze Shares. This means, for example, that if a family business has been frozen, it might be advantageous to sequester personally-held investments in the Frozen Corporation, so that the surplus balances can be used to reduce death tax exposure to the parent(s). The build up of investment income may also allow the Freeze Shares to be redeemed on a tax-effective basis during the parent(s) lifetime. If this can be done, it may avoid complex reorganizations after death (we will discuss post mortem planning in the next edition of our newsletter).

- **Family Ties.** Freeze structures should also be reviewed where there are changes to family circumstances, particularly where the freeze has been effected through a discretionary-type family trust. For example, if some but not all children have become involved in the family business, an "asymmetrical" distribution from the trust may be advisable, especially if the parents have assets outside of the freeze with which they can compensate non-participating children. However, trustees, especially other than the parents themselves, should consider their legal position in such circumstances, since, under trust law, they owe a "fiduciary duty" to the beneficiaries (even where the trust calls for wide

(continued on page 5)

discretion). It is therefore advisable for the Settlor of the trust (i.e., the person who formally establishes it) to write a “letter of wishes” to the trustees specifying how he or she wants the trust’s assets to be distributed. The letter of wishes, while not legally binding on the trustees, may nonetheless put them in a more defensible position with respect to

distributions from the trust. In addition, an effective estate plan should take into consideration family law provisions, particularly those dealing with the division of property in the event of a marriage breakdown, that can potentially affect the parent undertaking the freeze and the children beneficiaries.

Reviewing Estate Freezes – *Opportunities and Traps*

Courtesy of Canada’s never-ending tax changes, periodic review of an estate freeze may turn up both tax traps and opportunities. An example of each:

- **Refreeze At Lower Value.** In some cases, an estate freeze might be implemented, only to find that the value of the Frozen Corporation has depreciated. An obvious example could be shares of a tech company. In these circumstances, it would obviously be beneficial to undertake a new freeze at a lower value in order to decrease the death tax exposure. Although the CCRA had previously indicated that this may give rise to taxable benefits problems, a few years ago it reconsidered its position, so that the ability to re-freeze at a lower value is now open.
- **“Too Many Strings.”** Especially for older freezes, a tax trap arises where the so-called “reversionary trust rules” have ever applied to the trust. These rules are designed to operate where a contributor to the trust retains “too many strings” on it – basically, where he or she can dictate or veto who gets what, or simply take back his or her contribution. Such trusts are now subject to a dangerous tax trap: the shares or other assets in the trust can only be distributed on a tax-deferred basis to the contributor while he or she

is alive (such a distribution, would usually jeopardize the freeze).⁸ A distribution to other beneficiaries during this period may trigger a huge tax exposure. This rule is particularly problematic for older estate freezes: the rule came into effect in 1988 and there was no “grandfathering” for older trusts. A couple of other points to keep in mind:

- (i) The rules potentially apply to *any* contributor to the trust with “too many strings” on it, not necessarily the “Settlor,” who formally establishes the trust. So it may be advisable to review the mechanics of the freeze itself as well as subsequent transactions, especially for an older freeze.
- (ii) The reversionary trust rules may come into effect owing to a change of circumstances. One example is where the contributor started out as one of several trustees but other trustees resign or pass away. Even if the contributor is one of two trustees, he or she would then have a veto – and the rules would kick into effect.

1. Notes: Or a qualifying “spouse trust.”

2. The Freeze Share configuration is achieved by attaching a variety of terms and conditions to these shares. The most important of these is that the shares be redeemable by the corporation based on values at the time of the freeze, as well as being redeemable at the option of the holder (“retractable”) at the same value. In addition, the Freeze Shares typically provide for non-cumulative dividends at reasonable amounts, based on a percentage of the redemption amount. The parent(s) will also retain control of the Frozen Corporation through voting rights attaching either to the Freeze Shares themselves, or to a special class of shares in which voting rights are isolated. The Growth Shares held by the trust are typically ordinary common shares.

3. As will be discussed later, however, it may be advantageous to sequester such investments at the corporate level as part of a freeze of other assets, e.g., a family business.

4. See subsection 159(1) of the Income Tax Act (the “Act”).

5. Subject to consideration of the trustees’ fiduciary obligations.

6. To the extent that insurance proceeds generate “capital dividends.”

7. I.e., arrangements in place prior to Apr/27/95, which meet certain criteria.

8. Furthermore, the distribution may not be possible under the terms of the trust – i.e., if the contributor is not a beneficiary.

For further information, please contact a member of our Tax Group.

David Louis	(416) 369-4111	dlouis@mggg.com
Joan E. Jung	(416) 369-4306	jjung@mggg.com
Daniel Sandler	(416) 369-4308	dsandler@mggg.com
Michael A. Goldberg	(416) 369-4317	mgoldberg@mggg.com
Samantha A. Prasad	(416) 369-4155	sprasad@mggg.com
Salina Shum, Senior Law Clerk	(416) 369-4150	sshum@mggg.com

Minden Gross Grafstein & Greenstein LLP
111 Richmond St. W., Suite 700
Toronto, Ontario M5H 2H5
TEL: 416-362-3711 FAX: 416-864-9223

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FIRM NEWS

We are pleased to welcome to the firm

Anna L. Casemore
Litigation Group
(416) 369-4106
acasemore@mggg.com

Gale L. Tobin
Commercial Leasing Group
(416) 369-4105
gtobin@mggg.com

The firm congratulates Howard S. Black on his completion of an LL.M. in Alternative Dispute Resolution at Osgoode Hall Law School. Also, Howard has been elected the Vice-Chair of the Trusts and Estates Section Executive of the Canadian Bar Association (Ontario) for the 2001-2002 term.

The Employment & Labour Law Group will once again be hosting a series of breakfast seminars which will start this fall and continue through the winter of 2002. The first two seminars are:

- The New Employment Standards Act: The Employer's Guide – October 25, 2001
- Straight from the Source: Top 5 Lessons for Employers from our Courts – November 29, 2001

If you are interested in receiving more information about these seminars or other upcoming employment law seminars, please contact Tracy Kay at (416) 369-4330.

PROFESSIONAL NOTES

Arnie Herschorn spoke at a Continuing Legal Education conference on the topic of "At the Heart of Contract Law".

Tracy Kay spoke at a Human Resources Conference in Nashville, Tennessee on "Hot Topics for Human Resource Professionals in Canada".

Hartley R. Nathan, Q.C. lectured to the Bar Admission Course on Corporate Finance. Hartley also delivered a lecture to the UJWF Endowment Fund on "Due Diligence before and while serving as a director of a not-for-profit corporation". In September, Hartley spoke at the 3rd Annual Conference of the Canadian Society of Corporate Secretaries on recent amendments to the Canada Business Corporations Act.

This newsletter is based on articles also published by CCH Canadian Limited.