The Institute™
for Advanced Financial Education

COMMENT

Edition 320 - Sep/Oct 2020

A newsletter for CLU designation holders focusing on risk management, wealth creation, and preservation.

Estate Freeze and Refreeze in an Economic Downturn

Business owners typically consider tax planning at a time when their businesses are flourishing and their wealth is increasing. However, the COVID-19 pandemic — and the ensuing economic downturn — may also provide planning opportunities that can improve their tax situation. Let's discuss how business owners may achieve tax savings in the long run by implementing an estate freeze or a refreeze during an economic downturn, as well as the insurance opportunities they present.

ESTATE FREEZE

On death, business owners are deemed to have disposed of their private company shares at fair market value (FMV). The capital gains realized on the deemed disposition are taxable on their final returns. Thus, as the value of their businesses grows throughout their lifetime, the accrued gains in their shares can be substantial, which may result in significant taxes payable at death.

An estate freeze can cap a business owner's tax liability at death by freezing the value of his shares at today's FMV. In a typical scenario, the transaction involves a tax-deferred exchange of participating common shares for fixed value preferred shares. The fixed redemption value of the preferred shares will equal the FMV of the common shares at the time of the freeze. Assuming the preferred shares are held until death, this fixed redemption value will be the value on which the tax liability on the deemed disposition will be calculated. As a result, logically it follows that the lower the fixed redemption value of the shares, the lower the tax liability at death.

As mentioned, the fixed redemption value of the preferred shares would generally equal the FMV of the common shares exchanged. It should not be arbitrarily understated for purposes of reducing the associated tax liability. In fact, it is important that a professional valuation of the shares be obtained and a price-adjustment clause be included in the relevant agreements to avoid potential tax issues. However, where the value of the business has declined due to an economic downturn and it is expected that the business value will recover once the economic situation improves, this temporary reduction in business value presents a great planning opportunity to undertake an estate freeze.

For example, let us assume Mr. A wholly owns A Co. common shares. The value of these shares before the economic downturn was $5 million. The adjusted cost base (ACB) of the shares are nominal. As a result of the economic downturn caused by the pandemic, the value of the business declines to $3 million. However, Mr. A is optimistic that the business value will return to $5 million in year 2024.

As shown in Table 1, if no estate freeze was done and Mr. A happens to die in year 2024 after the business value returns to $5 million, his capital gains tax liability at an assumed tax rate of 25% will be $1.25 million. However, had he done an estate freeze today and he dies in year 2024, his capital gains tax liability will only be $750,000. This represents a tax savings of $500,000. In addition, assuming his will needs to be probated, doing the freeze today may also reduce the probate fees (assuming Ontario probate rate) on his shares by $30,000.

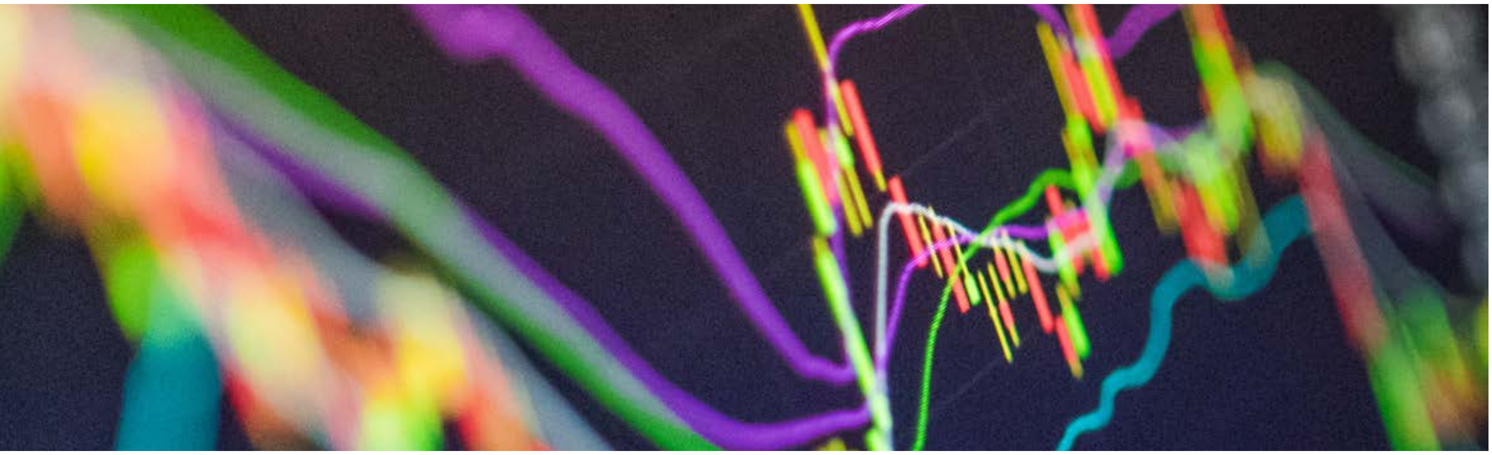

Table 1

Tax liability at death	Mr. A dies in 2024, without freeze	Mr. A dies in 2024, with freeze
Deemed proceeds	$5,000,000	$3,000,000
ACB	Nominal	Nominal
Capital gains	$5,000,000	$3,000,000
Tax @ 25%	$1,250,000	$750,000
Tax savings ($1.25m–$750k)		$500,000
Probate savings ($5m–$3m) x 1.5%		$30,000

An estate freeze conversation can easily lead to life insurance planning discussions. Once a freeze is done, the tax liability of the business owner is fixed and can be easily estimated. What is the business owner's plan in terms of funding this tax liability at death? What funding options are available? Life insurance is an obvious funding option and it often is the most cost-effective solution in many cases.

In addition to providing liquidity at death, life insurance may also be used in conjunction with post-mortem planning to generate tax efficiency. Let us further assume that A Co. owns a life insurance policy on Mr. A with a death benefit of $3 million and an ACB of nil at death. The credit to A Co.'s life insurance capital dividend account (CDA) will, therefore, be $3 million.

As shown in Table 2 on the next page, without life insurance and using the redemption with loss carryback post-mortem planning method, the dividend tax rate (assumed at 45%) will apply on the redemption of $3 million of preferred shares. However, where insurance planning is in place with $3 million of CDA credit available at death, the overall tax rate of the redemption with loss carryback planning can be reduced depending on how the redemption is structured (e.g., full CDA redemption, 50% solution, or spousal roll and redeem). Evidently, life insurance can help optimize the business owner's tax situation at death.

Table 2

Redemption and loss carryback – s.164(6)

	No insurance	With insurance (full CDA)	With insurance (50% solution)	With insurance (spousal roll and redeem)
FMV of shares	3,000,000	3,000,000	3,000,000	3,000,000
Less: tax on capital gains (assume tax rate of 25%)	-	375,000	-	-
Less: tax on dividend (assume tax rate of 45%)	1,350,000	-	675,000	-
Net funds to estate	**1,650,000**	**2,625,000**	**2,325,000**	**3,000,000**
Total tax as %	45.00%	12.50%	22.50%	0.00%
CDA credit remaining	-	-	1,500,000	-

REFREEZE

Some business owners may have previously done an estate freeze. If the economic downturn has significantly impacted the value of their business such that the overall value of their corporation is now less than the fixed redemption value of their freeze shares, a refreeze can be a great strategy to generate tax savings in the long run.

Consider the following example:

- Mr. B is the founder of B Co. He did an estate freeze in 2015 and received $6 million of fixed value preferred shares.
- A family trust was set up at that time to subscribe for newly issued common shares. The common shares have since grown and are worth $1 million.
- The total value of B Co., therefore, is $7 million ($6 million + $1 million).
- As a result of the economic downturn, the overall value of B Co. fell to $4 million.
- Mr. B expects the value of B Co. to return to $7 million or greater in a few years.

Preferred shareholders generally have a priority claim over common shareholders on the liquidation of a company. As a result, since the overall value of B Co. is now only $4 million, Mr. B's preferred shares are now worth only $4 million, despite having a fixed redemption value of $6 million. The existing common shares owned by the family trust would have nominal value. Mr. B may consider doing a refreeze to achieve tax savings.

A refreeze essentially involves converting the existing freeze shares into a new class of freeze shares, generally on a tax-deferred basis. This resets the fixed redemption value of the freeze shares to the current lower FMV. This planning may provide several tax benefits for Mr. B:

1. Lower capital gains tax at death

Resetting the freeze share value to $4 million from $6 million will reduce the fixed redemption value of Mr. B's preferred shares. Lower share value means lower tax liability at death, which creates tax savings.

2. Income splitting

Assuming Mr. B has been using the family trust structure to sprinkle dividends with his family members where the Tax on Split Income (TOSI) rules do not apply, such dividend payments may no longer be allowed if the value of his existing preferred shares is underwater. The reason for that is because the rights and restrictions of preferred shares generally require that dividends on common shares cannot be declared if the payment of dividends would reduce the value of the outstanding preferred shares.

By doing a refreeze to reset the preferred share value at today's lower value such that the preferred shares are no longer underwater, future profit may continue to

Table 3

Tax liability at death	Value recovered, without refreeze	Value recovered, with refreeze
Deemed proceeds	$6,000,000	$4,000,000
ACB	Nominal	Nominal
Capital gains	$6,000,000	$4,000,000
Tax @ 25%	$1,500,000	$1,000,000
Tax savings ($1.5m–$1m)		$500,000
Probate savings ($6m–$4m) x 1.5%		$30,000

be paid to common shareholders by way of dividends (subject to TOSI). As such, a refreeze may help facilitate existing income splitting planning.

3. Extending the 21-year deemed disposition date of a family trust

The existing family trust was set up in 2015. Its 21-year deemed disposition date would be around year 2036. Since the common shares owned by the 2015 family trust currently have nominal value, this family trust, together with the common shares it owns, can be wound up. A new 2020 family trust can be set up as a part of the refreeze to subscribe for newly issued common shares. This 2020 family trust would have its 21-year deemed disposition mark in year 2041, which is five years later than that of the 2015 family trust. This provides more tax deferral and more time for Mr. B to decide how to deal with the trust-owned shares.

With respect to final tax liability, Table 3 shows the tax and probate savings that may be achieved if Mr. B does a refreeze today at $4 million. As shown, a refreeze may result in $500,000 of tax savings and $30,000 in probate fee savings.

In terms of insurance opportunities, where the business owner has not considered insurance planning previously, a refreeze discussion may also lead to insurance planning opportunities similar to those discussed under the estate freeze.

Where insurance planning has been incorporated previously, a refreeze may reduce the amount of insurance protection needed in terms of the liquidity needs at death. An updated review of the business owner's insurance needs can help determine if any excess coverage can be used for other estate planning objectives, or if the coverage can be reduced to result in cost savings. More importantly, as the business recovers in value in the future, more growth will accrue to the common shareholders that are usually the next generation or a family trust for the benefit of the next generation. As such, the insurance needs of the next generation should be reviewed to determine if there is adequate insurance protection in place to address their liquidity and estate planning needs.

While an economic downturn may bring about financial challenges to many businesses, it may also provide some great tax planning opportunities. Helping business owner clients recognize the planning opportunities can help increase insurance advisors' value proposition, as well as lead to more insurance planning opportunities. ©

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