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ESTATE FREEZE

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INTRODUCTION

The *Income Tax Act (ITA)* states that a disposition of capital property, whether voluntary or involuntary (upon death), must be made at **fair market value (FMV)**. A disposition can result in capital gain and a significant tax liability that can reduce the estate bequeathed to heirs after death. The ITA provides **exceptions** to the deemed disposition of a deceased's capital property at FMV,¹ including the spousal rollover and rollovers to a parent or child in the farming and fishing industries. These tax breaks reduce the deceased's tax liability and increase the estate passed on to the heirs.

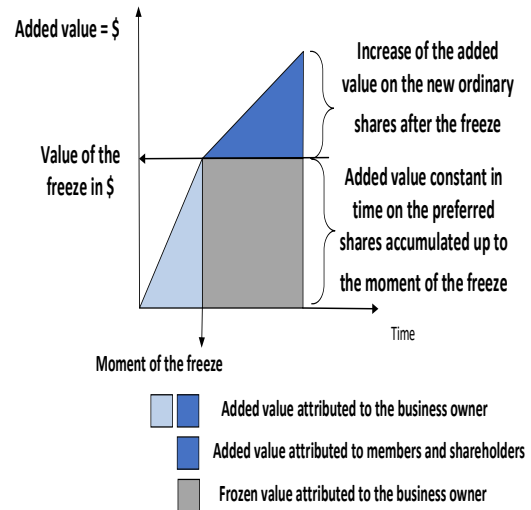
ESTATE FREEZE AT A GLANCE

These **tax breaks** are **limited in scope** when a deceased's estate is transferred to descendants outside the farming and fishing industries. To minimize the tax on capital gains arising from a disposition, tax specialists have developed estate freeze strategies to freeze the value of assets that gain value over time. By **implementing an estate freeze** during their lifetime, the author of the estate freeze can (1) **forecast** the amount of tax payable at their death and (2) **transfer** the capital gains on any subsequent increase in the value of their assets to their children and/or other shareholders while retaining control of the business, if desired.

The **estate freeze**, as illustrated below, should be part of a business owner's overall

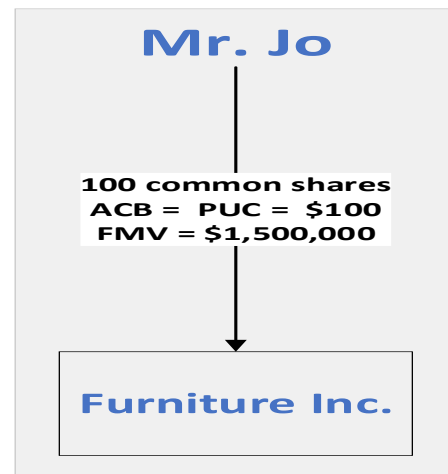
¹ See the text on taxation and death iA Large Case Solutions website: [Tax Implications Upon Death \(ia.ca\)](http://ia.ca).

tax and financial strategy.



IMPLEMENTING ESTATE FREEZES

This document focuses on issues to consider when implementing estate freezes for business owners operating active businesses.² In this document, we will **assume the following facts** to illustrate various estate freeze scenarios:



² Many other situations conducive to estate freezes are listed in Appendix A.

1. Mr. Jo is 50 years old and the sole shareholder of a corporation that manufactures furniture (Furniture Inc.).
2. Furniture Inc. is a [Canadian-controlled private corporation \(CCPC\)](#) and a [small business corporation \(SBC\)](#) in Canada.
3. The shares of Furniture Inc. are [qualified small business corporation \(QSBC\)](#)³ shares for the purposes of the [capital gain deduction \(CGD\)](#).⁴
4. The FMV of the shares of Furniture Inc. is \$1,500,000 with an [adjusted cost base \(ACB\)](#) and [paid-up capital \(PUC\)](#) of \$100.
5. Mr. Jo has a spouse, Mrs. Jo, who does not work for Furniture Inc.
6. Mr. and Mrs. Jo have three children aged 18, 20 and 22.
7. Mr. Jo's [marginal tax rate](#) is 53.53%.⁵
8. Mr. Jo has access to his CGD and there is no tax balance⁶ that reduces his CGD.
9. Looking at his sales, Mr. Jo predicts that the value of Furniture Inc. could increase to \$6,000,000 in the next ten years.

The following table illustrates the tax consequences of selling the shares of Furniture Inc. in [2024 versus 2034](#) if Mr. Jo maintains the current corporate structure for the next ten years without an estate freeze.

| | Year 2024 | Year 2034 |
|--------------------------------------|--------------------|--------------------------------|
| Proceeds of disposition (FMV) | \$1,500,000 | \$6,000,000 (estimated) |
| Less: ACB | \$100 | \$100 |
| Capital gain | \$1,500,000 | \$6,000,000 |
| Less: CGD | \$1,016,836 | \$1,016,836 ⁷ |
| Net capital gain | \$483,064 | \$4,983,064 |
| Taxable capital gain | \$241,532 | \$2,491,532 |
| Marginal rate tax (53.53%) | \$129,292 | \$1,333,717 |

The common shares of Furniture Inc. have [robust growth potential](#). Mr. Jo could end up with a significant tax liability if the corporate structure remains unchanged. Given the expected future growth in the value of Furniture Inc., an estate freeze could reduce Mr. Jo's future tax liability and/or spread it among other members of his family.

There are [several methods to implement estate freezes](#) depending on the clients' situation, needs and wishes,⁸ either with or without the use of holding corporations and/or trusts (see Appendix B for a summary of the benefits and drawbacks). The following three examples are presented for educational and informational purposes only. They illustrate the various steps

³ Subs. 110.6(1) ITA: [three criteria](#) to be qualified as QSBC: (1) ownership for [24 months](#) preceding the disposition, (2) [50%](#) of assets used actively during the 24 months and (3) [90%](#) of the assets used actively at the disposition.

⁴ In 2024, the CGD is \$1,016,836 and it is indexed annually.

⁵ In Ontario, refer to each province and territory as required.

⁶ [Allowable Business Income Loss \(ABIL\)](#), [Cumulative Net Loss on Investments \(CNIL\)](#).

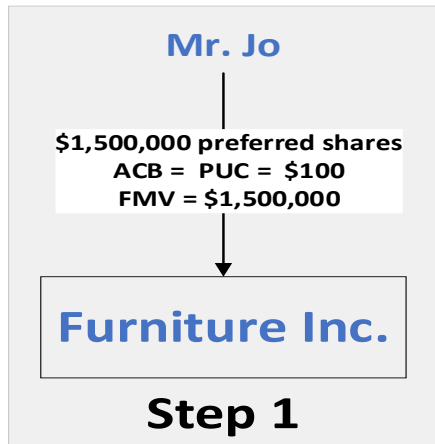
⁷ If the CGD remains the same in the future and the shares of Furniture Inc. continue to qualify as [QSBC](#) for CGD purposes.

⁸ Share conversion, declaration of stock dividend, share tax rollover or reorganization of share capital.

involved in implementing an estate freeze to produce different structures and outcomes.

Example 1 – Estate freeze without a holding corporation or trust

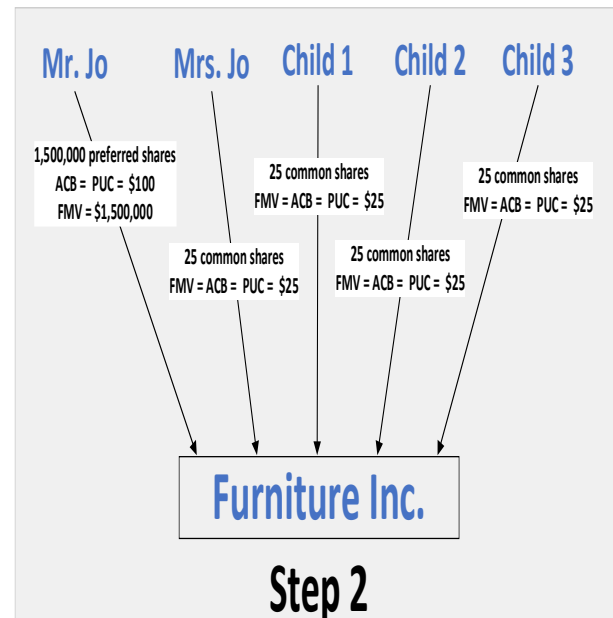
In Step 1, Mr. Jo's 100 common shares are frozen by:



1. converting⁹ the common shares into 1,500,000 preferred shares valued at one dollar per share at a cost of \$100; or
2. declaring¹⁰ a stock dividend of \$100 payable on the issuance of 1,500,000 preferred shares; or
3. rolling over¹¹ the common shares to Furniture Inc. for 1,500,000 preferred shares; or
4. reorganizing¹² the share capital of Furniture Inc., cancelling the common shares and issuing 1,500,000 preferred shares.

In Step 2, Mrs. Jo, Child 1, Child 2, and Child 3 each subscribe for 25 common shares of Furniture Inc. at \$25 each. Eventually, Mr. Jo may also subscribe for the common shares of Furniture Inc. to benefit from the future

growth of Furniture Inc. (not illustrated here).



Example 2 – Estate freeze with a holding corporation but no trust

In Step 1, Mr. Jo's 100 common shares of Furniture Inc. are rolled over to the newly incorporated holding corporation in exchange for 100 common shares of the new holding corporation.



⁹ Sec. 51 ITA.

¹⁰ Sec. 82 ITA.

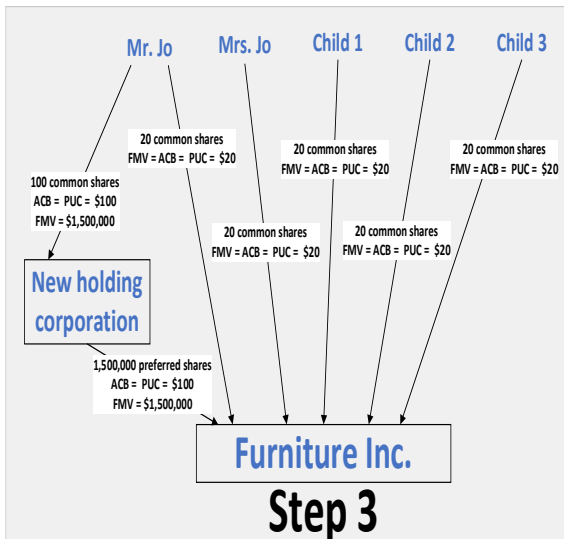
¹¹ Sec. 85 ITA.

¹² Sec. 86 ITA.

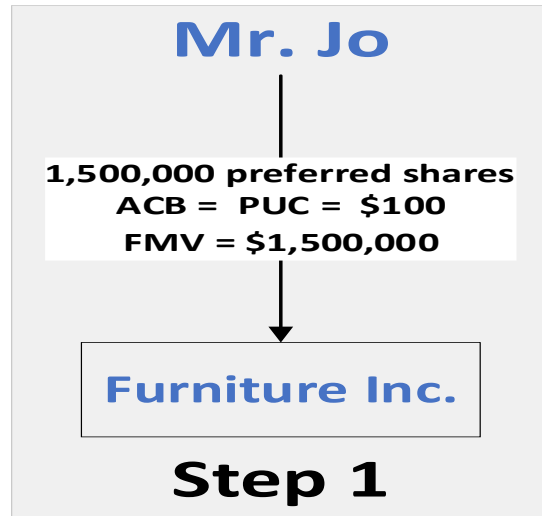
In Step 2, the 100 common shares of Furniture Inc. held by the new holding corporation are frozen by way of a tax rollover, conversion, or reorganization of the share capital of Furniture Inc.



In Step 3, Mr. Jo, Mrs. Jo, Child 1, Child 2, and Child 3 each subscribe for 20 common shares of Furniture Inc. at \$20. Eventually, Mr. Jo may choose not to subscribe to the common shares of Furniture Inc. if he does not want to benefit from the future growth of Furniture Inc. (not illustrated here).



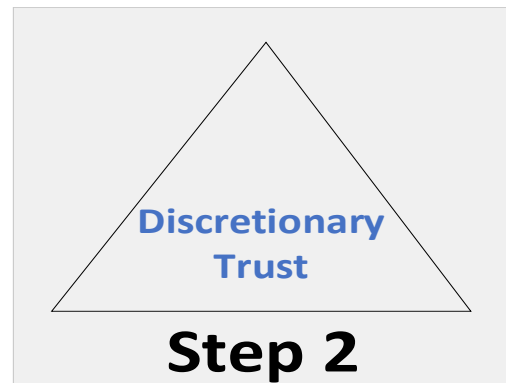
Example 3 – Estate freeze without a holding corporation but with a trust



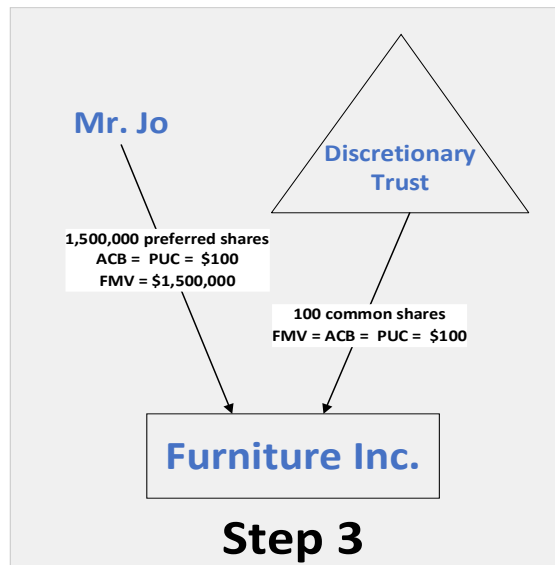
In Step 1, Mr. Jo’s 100 common shares are frozen by way of conversion, tax rollover, reorganization of the share capital of or declaration of stock dividend payable by issuance of preferred shares.

In Step 2, Mr. Jo creates a discretionary trust whose beneficiaries are:

1. Family members: Mr. Jo and Mrs. Jo; Child 1, Child 2, Child 3; Grandchildren;
2. Entities: corporations created by Mr. Jo or one of the beneficiaries; Trusts.



In Step 3, the trust subscribes for 100 common shares of Furniture Inc. at \$100.



REASONS FOR AND BENEFITS OF AN ESTATE FREEZE

Lock in the value for a future sale

The estate freeze on the shares of Furniture Inc. will fix the price at which Mr. Jo can sell the 1,500,000 preferred shares of Furniture Inc. to future buyers. The existing value of the common shares is reflected in the frozen preferred shares at a predetermined and fixed redemption value (at FMV). The new common shares issued to shareholders will benefit from future accrued gains.

In examples 1 and 3 above, Mr. Jo can determine the capital gain and tax consequences of selling his preferred shares of Furniture Inc. because the value of the frozen preferred shares and the potential capital gain are known and will remain unchanged in the future. In Example 2

above, the price freeze was implemented on the 1,500,000 preferred shares of Furniture Inc. held by the new holding corporation. The result is that the potential capital gain on the disposition of the 1,500,000 preferred shares of Furniture Inc. held by the new holding corporation is also known. However, Example 2 presents a drawback if Mr. Jo decides to invest in the new holding corporation. This is because the value of these investments may change and may affect the total value of the holding corporation, in which case the potential capital gain on the preferred shares would be unknown.

Lock in the value in the event of death and anticipate probate fees

By freezing the value of Furniture Inc. on the 1,500,000 preferred shares, Mr. Jo can predetermine the tax impacts, the amounts, and the assets to be included in his estate for probate purposes. Knowing the value of his estate, Mr. Jo will be able to plan for the expenses related to his death as well as financing for the probate fees.¹³

Introduction of new members to the shareholding structure: children, key employees, and corporate entities

Following an estate freeze, new members will subscribe for new common shares. The new shareholders may be family members and people related to Mr. Jo, or key employees of Furniture Inc. By subscribing for the new common shares, the new shareholders of Furniture Inc. will benefit from Furniture Inc.'s growth and increase in value. This potential may encourage the new

¹³ Probate fees apply in all territories and provinces of Canada except Quebec.

shareholders to make a long-term commitment to the business of Furniture Inc. and work hard to preserve and grow the business since the corporation would become an important asset in their wealth.

Gradual transfer by the original shareholder

As part of the estate freeze, Mr. Jo would personally receive frozen preferred shares¹⁴ of Furniture Inc. These frozen preferred shares will allow Mr. Jo to **maintain control** of Furniture Inc. for a period and to **gradually transfer control over** to the new members. Mr. Jo may gradually withdraw from the day-to-day operations of Furniture Inc. and shareholding by progressively disposing of his frozen preferred shares by redemption¹⁵ or sale¹⁶ over time. If his frozen preferred shares have sufficient votes, Mr. Jo could retain control of Furniture Inc. until he no longer owns any frozen preferred shares.

Tax impacts of an estate freeze

An estate freeze allows for the pre-determination of tax consequences on the frozen preferred shares and reduces the tax impacts on the common shares of Furniture Inc. The **following illustrations** summarize the potential reduction in tax liability of the

entire family unit resulting from the estate freeze, not including the **alternative minimum tax (AMT)**. The AMT is a minimum tax targeting high-income individuals who benefit from certain tax advantages (such as the CGD) that **reduce or eliminate** their tax obligations.

AMT is payable if the **minimum tax calculation is higher than taxes calculated the regular way**. The alternative minimum tax is a complex calculation based on an adjusted taxable income using a basic AMT exemption amount.¹⁷ If the tax benefits claimed, such as the CGD, significantly exceed this **exemption amount**, the individual may have to pay an AMT¹⁸ because this minimum tax will be higher than their regular tax.

In the following illustrations, it is assumed that:

- Furniture Inc.'s value has increased from \$1,500,000 to \$6,000,000 over ten years;
- the Furniture Inc. shares are eligible for the CGD on the sale of the business in 2034¹⁹; and
- the value of the new holding corporation in Example 2 remains unchanged.

¹⁴ Preferred shares redeemable at the option of the holder.

¹⁵ Redemption by Furniture Inc. does not qualify for the CGD.

¹⁶ Sale could qualify for the CGD.

¹⁷ The calculation of the AMT has changed on January 1, 2024: additional limits on deductions and credits, increase in the AMT tax rate to **20.5%** at the federal level and **19%** in Quebec, and an increase of \$40,000 in the AMT exemption

on an individual's annual income to around **\$173,000** at the federal level and **\$175,000** in Quebec.

¹⁸ The AMT paid in a year in excess of the regular tax can be carried forward to the next seven years and deducted from the tax payable in excess of the AMT payable.

¹⁹ Except for the preferred shares of Furniture Inc. held by the new holding corporation in Example 2.

| | Sale in 2024 | Sale – No estate freeze | Sale – Example 1 | Sale – Example 2 | Sale – Example 3 |
|---|--------------------|-------------------------|------------------------------|------------------------------|------------------------------|
| Sale (FMV) – Common shares | \$1,500,000 | \$6,000,000 | \$4,500,000 | \$4,500,000 | \$4,500,000 |
| Less: ACB | (\$100) | (\$100) | (\$100) | (\$100) | (\$100) |
| Capital Gain | \$1,499,900 | \$5,999,900 | \$4,499,900 | \$4,499,900 | \$4,499,900 |
| Less: CGD ²⁰ (Mr. Jo) | (\$1,016,836) | (\$1,016,836) | | | |
| Less: CGD (post freeze to family members) | | | (\$4,067,344) [4 members] | (\$5,084,180) [5 members] | (\$5,084,180) [5 members] |
| Net capital gain | \$483,064 | \$4,983,064 | \$432,556 | \$0 | \$0 |
| Taxable capital gain | \$241,532 | \$2,491,532 | \$216,278 | \$0 | \$0 |
| Personal tax – 53.53% | \$129,292 | \$1,333,717 | \$115,774 | \$0 | \$0 |

| | Sale in 2024 | Sale – No estate freeze | Sale – Example 1 | Sale – Example 2 | Sale – Example 3 |
|--------------------------------------|--------------|-------------------------|--------------------|--------------------|--------------------|
| Sale (FMV) – Preferred Shares | | | \$1,500,000 | \$1,500,000 | \$1,500,000 |
| Less: ACB | | | (\$100) | (\$100) | (\$100) |
| Capital Gain | | | \$1,499,900 | \$1,499,900 | \$1,499,900 |
| Less: CGD ²¹ (Mr. Jo) | | | (\$1,016,836) | | (\$1,016,836) |
| Net capital gain | | | \$483,064 | \$1,499,900 | \$483,064 |
| Taxable capital gain | | | \$241,532 | \$749,950 | \$241,532 |
| Personal tax – 53.31% | | | \$129,292 | | \$129,292 |
| Corporate tax – 50.17% | | | | \$376,250 | |

| | Sale in 2024 | Sale – No estate freeze | Sale – Example 1 | Sale – Example 2 | Sale – Example 3 |
|---|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| NET – Mr. Jo and 4 members | \$1,370,708²² | \$4,666,283²³ | \$5,754,934²⁴ | \$5,623,750²⁵ | \$5,754,934²⁶ |
| NET – Mr. Jo and more than 4 members | --- | --- | --- | --- | \$5,871,239²⁷ |

²⁰ Assuming that the CGD remains unchanged in the next ten years, and the corporation continues to qualify for CGD purposes at the time of disposition of the QSBC shares.

²¹ *Ibid.*

²² \$1,500,000 - \$129,292.

²³ \$6,000,000 - \$1,333,717.

²⁴ \$6,000,000 - \$129,292 - \$115,774 (the four members are Mrs. Jo, Child 1, Child 2, and Child 3).

²⁵ \$6,000,000 - \$376,250 (the five members are Mr. Jo, Mrs. Jo, Child 1, Child 2, and Child 3).

²⁶ \$6,000,000 - \$129,292 - \$115,774 (the four members are Mrs. Jo, Child 1, Child 2, and Child 3).

²⁷ \$6,000,000 - \$129,292 (five members are Mrs. Jo, Child 1, Child 2, Child 3, and a beneficiary of the Trust such as a grandchild).

These illustrations are for educational purposes only and illustrate the benefits of implementing an [estate freeze](#):

1. In Case 1: a difference of \$1,088,651²⁸ for the family unit;
2. In Case 2: a difference of \$957,467;²⁹
3. In Case 3: a difference of \$1,088,651³⁰ (if four members claim the CGD) or \$1,204,425³¹ (if five members claim the CGD).

These illustrations also demonstrate [the benefit of using a discretionary trust](#) when implementing an estate freeze, as shown in Example 3. In this example, an additional individual beneficiary of the trust, such as a grandchild born after the [estate freeze](#) was created could claim the CGD and limit the tax on death or on the disposition of Furniture Inc. shares. Indeed, the trust allows for “[multiplication](#)” (increase in the number of potential beneficiaries) of the CGD available to the trust beneficiaries if the trust holds [QSBC](#) shares.

Financing the transfer

When transferring a family business to related persons, [financing the transaction is often a concern](#). Without an estate freeze, Mr. Jo’s children would need sufficient funds to pay the FMV of Mr. Jo’s shares (\$6,000,000 in 2034 based on the above assumptions) in a lump sum or in several instalments.³² Without an estate freeze, the three children would each have to pay

\$2,000,000 to acquire Mr. Jo’s shares of Furniture Inc. [Financing options](#) would be limited since the children would not have accumulated enough assets to purchase the shares held by Mr. Jo, since they would only be 28, 30 and 32 years old in 2034.

In this situation, an estate freeze would alleviate need for Mr. Jo’s children to finance \$2,000,000 each in 2034. An estate freeze would freeze the current value of Furniture Inc. at \$1,500,000 on the 1,500,000 preferred shares. As a result, Mrs. Jo and the children would subscribe to the common shares at a nominal amount with no financing difficulties. Furniture Inc.’s [future growth](#) of \$4,500,000 after the estate freeze in 2024 will benefit Mrs. Jo and the children since they would have purchased the shares for a nominal amount.

Trust and asset protection

A trust is a [separate patrimony](#) from the patrimony of the trust’s settlor. In an estate freeze, a trust is created by a contract under which the trust’s settlor transfers assets from the estate to the trust’s patrimony for a particular purpose. The assets are accepted by the trustees, who agree to hold and administer/manage them for the benefit of the trust beneficiaries. Since the trust’s assets are part of the trust’s patrimony and are distinct and separate from the settlor’s patrimony, the property is protected from

²⁸ \$5,754,934 - \$4,666,283.

²⁹ \$5,623,750 - \$4,666,283.

³⁰ \$5,754,934 - \$4,666,283.

³¹ \$5,870,708 - \$4,666,283.

³² The ITA allows a selling parent to claim a 10-year reserve on the sale of [QSBC](#) shares to their children so the children can pay the purchase price over 10 years.

creditors³³ of the trust's settlor who originated the estate freeze.

Need for life insurance to ensure equity between children

During the estate freeze, some of Mr. Jo's children may choose **not to be involved in** the operation of Furniture Inc. In such a scenario, the client may consider **buying life insurance** to leave an **inheritance** to the children who are inactive in Furniture Inc. Once Mr. Jo's shares are frozen, Furniture Inc. can issue **common shares** for a nominal amount to the children active in the business and **life insurance shares** for a nominal amount to the inactive children. **The life insurance shares'** characteristics would be linked to the life insurance contract. Thus, the value of the life insurance shares would track the value of the life insurance contract, i.e., the cash value during the business owner's lifetime and the insurance proceeds at death. The life insurance shares can also be non-voting and non-participating.

Once the life insurance shares are issued, Furniture Inc. would purchase a life insurance policy and name the corporation as beneficiary. On the death of the insured, the **insurance proceeds** (less the adjusted cost base (**ACB**)) would be credited to Furniture Inc.'s **capital dividend account (CDA)**. Furniture Inc. can redeem the life insurance shares held by the inactive

children and declare a tax-free **capital dividend** to them through its CDA.

The life insurance contract can provide an **equitable or fair distribution** following Mr. Jo's death, ensure **prompt payment**³⁴ of the death benefit to the inactive children, and **prevent conflicts** between the inactive children, who may feel they are being treated unfairly, and the children who are active in the business, who may be frustrated that they must continue to generate value and income in the business for the benefit of the inactive children.

POINTS TO CONSIDER WHEN IMPLEMENTING AN ESTATE FREEZE

Valuation of shares

During an estate freeze, it is crucial to determine the FMV of corporation's shares when a **family business is transferred**.³⁵ The Canada Revenue Agency (**CRA**) generally defines FMV as the "highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between informed, knowledgeable and prudent parties acting at arm's length, neither party being under any compulsion to transact."³⁶

Determining the FMV of the transferred or frozen shares is a serious and recognized valuation that shall be performed by a **certified appraiser**. In their evaluation, the

³³ A trust cannot be set up to defraud creditors.

³⁴ A shareholders' agreement could be useful and necessary.

³⁵ The transfer of property to a related person must be made at FMV.

³⁶ CRA, *Information Circular IC-89-3*, "Policy Statement on Business Equity Valuations," August 25, 1989, paragraph 3(a).

appraisers shall weigh in [several factors](#) to determine the FMV of Furniture Inc.'s shares, including:

- a. liquidation value;
- b. annual profits;
- c. FMV of the corporation's tangible and intangible assets, such as inventory, equipment, rolling stock, goodwill;
- d. comparable businesses.

This valuation is [critical](#) because there are tax consequences under the ITA if the value of the initial shares differs from the value of the frozen preferred shares issued during the estate freeze, such as a reduction in the preferred shares' cost³⁷ or the immediate taxation of a benefit to the author of the estate freeze.³⁸

Characteristics of frozen preferred shares

Once the 2024 value of Furniture Inc. is determined, this value is frozen or set at \$1,500,000 on the 1,500,000 frozen preferred shares of Furniture Inc., as illustrated above in examples 1 to 3. To be valid, it is therefore important that the frozen preferred shares meet the [tax requirements](#) established by the tax authorities.

A key feature of frozen preferred shares issued during an estate freeze is that the shares are [redeemable at the shareholder's discretion](#) at a value equal to the [FMV of the common shares](#).³⁹ In addition, the [preferred](#)

[shares' characteristics](#) cannot be changed, and their redemption value cannot be reduced below the common shares' FMV at the time of the estate freeze by declaring dividends on other share classes, by purchasing or redeeming the preferred shares below their redemption value, or by the terms and conditions of a shareholders' agreement.

Shareholders' agreement

As a result of the estate freeze, new members will become shareholders of Furniture Inc., such as Mr. Jo's family members or key employees. As soon as a corporation has more than one shareholder, it is recommended that a shareholders' agreement be put in place as soon as possible while there is harmony among the shareholders. For more information on [shareholders' agreements](#), visit the iA Large Case Solutions website at: [Shareholder Agreement: Life Insurance, a Valuable Tool in the Event of Death \(ia.ca\)](#).

ESTATE FREEZE ISSUES AND DISADVANTAGES

Canadian residency of the trust

For ITA purposes, a [trust is resident in the place](#) where its bona fide business is operated, that is, the place where its [central control and management](#) are exercised. The trustees of the trust exercise the

³⁷ See 51(2), 85(1) (e.2) and 86(2) of the ITA wherein the reduction of the ACB could increase the capital gain realizable on a future sale. See 51(3), 85(2.1), and 86(2.1) of the ITA wherein the reduction of the PUC could increase the dividend deemed realizable on a potential share redemption.

³⁸ Subsection 15(1) of the ITA: if the value of the original shares is less than the value of the frozen preferred shares.

³⁹ In certain cases, the redemption value of the preferred shares may include declared and unpaid dividends in addition to the FMV of the common shares.

management and control of a trust. Where there is more than one trustee responsible for the central management and control of the trust, the place of residence of the trust is the place where **the most substantial part of its central management and control** are exercised,⁴⁰ based on the specific facts of each situation. As a result, the Canadian residency of the trust will need to be verified each time the trustees and their successors emigrate from Canada.⁴¹

Deemed disposition of a trust's assets after 21 years

The ITA states that a trust is deemed to have disposed of its assets at fair market value on the **21st anniversary** of its creation and to have reacquired its assets immediately thereafter for an amount equal to that value.⁴² Where the assets held by the trust have increased in value and there is an unrealized gain, the deemed disposition could **result in a significant tax liability**.

In the context of an estate freeze such as Mr. Jo's case, the goal would be for him to withdraw from the activities of Furniture Inc. before the 21st anniversary of the trust. If Mr. Jo is not ready to retire before the 21st anniversary, there are **solutions to minimize the tax consequences** of the 21-year rule while allowing Mr. Jo to maintain appropriate control and protection of the assets. Therefore, clients and their tax professionals should keep track of the trust's 21st anniversary.

⁴⁰ The place of **residence of the trustees** does not determine the place of **residence of the trust**.

⁴¹ **Changing the trust's Canadian residency** can have tax consequences that clients and their professionals should assess at the appropriate time.

⁴² By 104(4) of the ITA.

Attribution rules

The potential application of **attribution rules** is another factor to analyze when implementing an estate freeze. Under these rules, the income and capital gains accrued on the new common shares that were issued as part of the estate freeze may be **attributed to the author** of the estate freeze rather than to the holders of the new common shares. If the attribution rules apply, they could **nullify some of the expected benefits of an estate freeze**. These attribution rules⁴³ are intended to restrict the use of estate freezes to prevent abuse.

Dividends received and allocated to individual beneficiaries: tax on split income

After implementing of an estate freeze, Furniture Inc. may declare and pay a dividend (in cash or in kind) directly to family members or through the trust, which allocates it to family members. A dividend received by an individual is normally taxable based on the recipient's tax bracket. However, if the dividend is paid to a specified individual, that individual may be subject to **the tax on split income (TOSI)**. A **specified individual** is an individual who was resident in Canada at the end of a taxation year⁴⁴ or, if they were under 17 years of age, one of their parents was a resident of Canada at any time during that year.

TOSI has **negative consequences** for specified individuals:

⁴³ There are **exceptions** to the application of the attribution rules: small business corporations or family members over the age of eighteen.

⁴⁴ **In case of death**, the individual must have been resident in Canada immediately before death.

- taxation at the highest tax rate on certain types of income⁴⁵, known as split income;
- tax credits restricted to dividend tax credits, foreign tax credits, and disability tax credits;
- loss of personal credits and other tax credits, including charitable donation tax credits.

Split incomes⁴⁶ subject to TOSI include but is not limited to:

- dividends on a share of a corporation received directly or through a partnership or trust;⁴⁷
- a shareholder benefit on a share of a corporation granted directly or indirectly through a trust or a partnership;
- a taxable capital gain or a benefit from the disposition of a share of a corporation by or allocated to a specified individual by a trust or partnership.

There are several exceptions to TOSI rules, such as:

- a taxable capital gain arising from the deemed disposition on death;⁴⁸
- a taxable capital gain from the disposition by an individual of property that was a QSBC share at the time of disposition;

- an excluded business, which applies when an individual is actively involved in the activities of a business on a regular, continuous, and substantial basis (an average of at least 20 hours per week);
- excluded shares.

Thus, if Mrs. Jo, Child 1, Child 2, and Child 3 are regular, continuous, and significant contributors to the Furniture Inc. business because of the estate freeze, the income paid to Mrs. Jo and the three children would not be subject to the adverse tax effects of TOSI rules.

Dividends received and allocated to corporate beneficiaries: safe income

After implementing an estate freeze as illustrated in examples 2 and 3 above, Furniture Inc. may declare and pay a dividend (in cash or in kind)⁴⁹ directly to the new holding corporation or through the trust, which allocates it to a holding corporation. A dividend received by a corporation is normally non-taxable to the corporation receiving the dividend,⁵⁰ subject to subsection 55(2) of the ITA.⁵¹

Section 55 of the ITA is a complex anti-avoidance tax rule intended to convert a tax-free dividend declared and paid to a corporation into income taxed as a capital gain for the corporation receiving the dividend. Subsection 55(2) of the ITA and its

⁴⁵ With the exception of excluded amounts that are not subject to TOSI rules under section 120.4 of the ITA.

⁴⁶ Subsection 120.4(1) of the ITA under the definition of “split income”: shares of publicly traded corporations and the share capital of a mutual fund corporation are not subject to TOSI rules.

⁴⁷ *Ibid.*: other than a mutual fund trust and a trust deemed to relate to a congregation (s. 143(1) of the ITA).

⁴⁸ Subsection 120.4(1) of the ITA under the definition of “excluded amount”.

⁴⁹ An example of a dividend in kind would be when transferring a life insurance policy from Furniture Inc. to a corporate beneficiary of the trust. See the iA Large Case Solutions website: [Transfer of Ownership of a Life Insurance Policy Involving a Corporation \(ia.ca\)](#).

⁵⁰ Subsection 112(1) of the ITA.

⁵¹ See also Part IV of the ITA.

exceptions,⁵² such as safe income,⁵³ should be reviewed as soon as dividends are declared to corporations. [Subsection 55\(2\) of the ITA and the concept of safe income](#) are complex and apply regardless of an estate freeze.

Section 84.1 of the ITA – Potential tax risks of an estate freeze

According to the ITA, the [acceptable way](#) to pay out a corporation's profits is to declare a taxable dividend at the individual's maximum marginal rate (such as 48.70% in Quebec or 47.74% in Ontario in 2024),⁵⁴ subject to certain exceptions.⁵⁵ However, distribution of a corporation's assets by means other than a taxable dividend constitutes [surplus stripping](#) and is contrary to the [fundamental tax principle of integration](#). Section 84.1 of the ITA is intended to prevent surplus stripping at capital gains tax rates (26.65% in Quebec or 26.76% in Ontario for example)⁵⁶, instead of the maximum marginal tax rates on individuals mentioned above.

Section 84.1 of the ITA⁵⁷ could result in a tax risk when implementing an estate freeze if the author of the freeze receives consideration other than shares in addition

to the frozen preferred shares. To illustrate the application of section 84.1 of the ITA, at step 1 of example 2 above, imagine that the 100 common shares of Furniture Inc. held by Mr. Jo are rolled over to the new holding corporation in exchange for a promissory note of \$500,000 and 1,000,000 preferred shares of Furniture Inc., instead of 1,500,000 frozen preferred shares. In that scenario, the cumulative conditions⁵⁸ of section 84.1 of the ITA would be met, particularly the fourth criterion, which is that the transferor and the purchaser do not deal at arm's length. The \$500,000 promissory note would be considered a deemed dividend for Mr. Jo taxable at the marginal rate of ordinary dividends instead of the marginal rate of a taxable capital gain, [a difference of more than 20%](#).

The application of section 84.1 of the ITA is broad and applies to the cases illustrated in the preceding paragraph and in cases of a sale of shares to the corporation of a [person related to the seller](#), for the purpose of realizing a capital gain. In both situations, section 84.1 of the ITA will recharacterize the capital gain as a taxable dividend to Mr. Jo, who will not be able to claim his CGD. However, section 84.1 of the ITA does not apply in the case of a sale to the corporation of a [person dealing at arm's length with the](#)

⁵² The application of Part IV is an exception to the application of subsection 55(2) of the ITA.

⁵³ [Safe income](#): if a declared dividend is less than the paying corporation's available safe income, subsection 55(2) of the ITA does not apply. Safe income is essentially a corporation's retained earnings, subject to tax adjustments, which will be used to pay dividends. The concept of safe income is complex and is beyond the scope of this text.

⁵⁴ In 2024, for example, 48.89% in British Columbia, 42.30% in Alberta.

⁵⁵ Capital dividend through the CDA.

⁵⁶ In 2024, for example, 26.75% in British Columbia, 24.00% in Alberta.

⁵⁷ Paragraph 84.1(1)(b) of the ITA.

⁵⁸ The [six application criteria](#) are as follows: (1) The transferor is an individual (including a trust) resident in Canada; (2) the purchaser is a corporation; (3) the property transferred by the transferor to the purchaser is a share of a corporation resident in Canada; (4) the transferor and the purchaser do not deal at arm's length; (5) the acquirer and the acquired company are connected companies immediately after the transaction; and (6) the non-share consideration (the promissory note) received by the transferor exceeds the greater of: (a) tax paid-up capital of the shares transferred by the transferor to the purchaser; or (b) "modified" ACB of shares transferred by the transferor to the purchaser.

seller, and the seller's gain is a capital gain. Thus, section 84.1 of the ITA is an unfair provision when transferring to a related person (i.e., children) compared to transferring to an unrelated person.

AMENDMENTS TO SECTION 84.1 OF THE ITA – EFFECTIVE ON JANUARY 1, 2024

In 2021 and 2023, the federal government amended section 84.1 of the ITA to allow transfers to children and other persons related to the transferor without penalty, provided they meet certain criteria. The goal of these amendments is to alleviate the tax injustice associated with a true intergenerational transfer of a business, since buyers unrelated to the seller benefited more from a tax point of view than buyers related to the seller (see previous paragraph).

Therefore, to facilitate a true business transfer to people related to the seller, the legislative amendments eliminate the application of section 84.1 of the ITA where the purchaser does not deal at arm's length with the seller, provided that several criteria⁵⁹ are met in the case of (1) "immediate transfers" made within 36 months or (2) "gradual transfers" made over a five- to ten-year period. Where these criteria are met and a joint election is made by the seller and purchaser, the intergenerational business transfer is

excluded from the deemed dividend rules of section 84.1 of the ITA, and the seller's capital gain will qualify for the CGD.

CONCLUSION

An estate freeze is a tax planning strategy with many financial, tax, personal (equitable distribution between children) and business (gradual business transfer) benefits. Given these benefits, estate freezes should be part of any business owner's comprehensive retirement and financial plan. However, estate freezes may also have disadvantages depending on their structure, as discussed above. There are exceptions to these disadvantages, and these are beyond the scope of this document.

The estate freeze methods presented in this document are not exhaustive. Every situation is unique, and clients are encouraged to consult their tax, legal and accounting professionals to explore estate freeze opportunities that are tailored to their situation and appropriate for their overall retirement and financial plans. Estate freeze planning is also an ideal time for clients to draft and/or review all their legal documents, such as shareholder agreements, wills, powers of attorney, life insurance policies, critical illness insurance policies, disability insurance policies and more.

⁵⁹ Examples: a small business corporation or a family farm or fishing business that is eligible for the CGD.

APPENDIX A: OTHER SITUATIONS CONDUCTIVE TO AN ESTATE FREEZE

The ideal situations for an estate freeze have some or all the following characteristics:

■ ■

The size of the operating corporation is such that the taxpayers would use their CGD upon disposing of the corporate shares. The taxpayers have a spouse and/or children who have not yet used their CGDs, and the operating corporation is expected to expand significantly in the future.

■ ■

The taxpayers hold a portfolio of investments, either within a corporation or as a person, who have sufficient value today to ensure a comfortable retirement in the future.

■ ■

The taxpayers have sufficient assets to enjoy a comfortable retirement, even after considering the effects of inflation.

■ ■

One or more of the taxpayers' adult children have incomes not taxed at the highest tax bracket.

■ ■

The taxpayers provide financial assistance to one or more of their adult children whose incomes are not taxed at the highest tax bracket (for example, a child in university).

■ ■

The taxpayer own shares of an operating corporation and one or more of their children have shown a strong interest in continuing operating the family business after the taxpayers' death or retirement.

■ ■

The taxpayers have sufficient assets to fulfill their retirement needs in and reside in a jurisdiction with high probate fees (for example, Ontario and British Columbia).

■ ■

The taxpayers have sufficient assets to fulfill their retirement needs and have children from a previous relationship to whom they want to transfer significant assets before their death.

■ ■

The taxpayer own shares of an operating corporation that may be subject to litigation in its operations making the taxpayers consider gifting surplus funds to their children for creditor protection purposes (assuming the taxpayer has sufficient assets to fulfill their retirement needs).

APPENDIX B: BENEFITS AND DRAWBACKS OF DIFFERENT METHODS OF ESTATE FREEZE

| | With or without a holding corporation | With a trust |
|-----------|--|--|
| Benefits | <ul style="list-style-type: none"> • Ability to reduce the “frozen value” over time and the tax payable on the frozen shares at Mr. Jo's death by redeeming the shares • Lower cost to implement and maintain the structure • Simpler and leaner administrative structure | <ul style="list-style-type: none"> • More versatile structure • Ability to implement a continuous purification structure for Furniture Inc. • Asset protection from creditors • Ability to reduce the “frozen value” over time and the tax payable on the frozen shares at Mr. Jo's death by redeeming shares • Multiplication of the CGD of the existing and the identifiable beneficiaries at the time of the estate freeze |
| Drawbacks | <ul style="list-style-type: none"> • Less versatile structure • Purification of Furniture Inc. possible with tax consequences for shareholders who are individuals • Multiplication of the CGD limited to existing shareholders at the time of the estate freeze | <ul style="list-style-type: none"> • Higher cost to implement and maintain the structure • More complex structure administratively • Deemed disposition rule for the trust every 21 years |

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