C. ESTATE FREEZES AS A TAX DEFERRAL TECHNIQUE [§1.13]

One goal of an estate freeze is to reduce the tax liability that arises on death by reducing the size of a taxpayer's estate by directing future growth to the taxpayer's children or grandchildren. Therefore, an estate freeze is a mechanism to potentially defer some of the tax that would otherwise be payable on a taxpayer's death until the death of their children or grandchildren. If the property being frozen will be disposed of immediately following the parent's death, no tax will be deferred.

An estate freeze can be completed on a tax-free basis by transferring business or investment assets to a corporation or by simply reorganizing the capital of an existing corporation. The transferor receives fixed-value, redeemable, retractable preferred shares, and causes common shares to be issued to their children or grandchildren, or a trust created for the benefit of such persons.

In some cases, a taxpayer's shares in a corporation can gradually be redeemed, at little or no additional tax cost, resulting in a gradual elimination of the tax liability that would otherwise arise on death. This technique is discussed at "Wasting Estate Freezes" in this chapter. See also "Wasting Estate Freeze" in chapter 2.

D. DIVIDEND STRIPPING: SECTION 55 OF THE *INCOME TAX ACT* [§1.14]

With great care, given the complexity of s. 55 of the *ITA*, parents can "sell" shares to children by using a dividend-stripping transaction that defers the payment of tax if the sale proceeds are left in a corporation. As soon as funds are removed from the corporation, the deferral is lost. Dividend-stripping transactions disguise the sale of shares (or other assets) by converting what would otherwise be proceeds from the sale of shares into the tax-free inter-corporate redemption of shares.

Section 55(2) recharacterizes certain receipts that would otherwise be tax-free inter-corporate dividends as proceeds of disposition of shares, which generally results in a capital gain being realized. But for s. 55(2), shares of corporations (or other assets) could almost always be sold tax-free by changing sales proceeds into tax-free inter-corporate dividends. As mentioned, tax would not be payable by an individual vendor until the "sales proceeds" were paid out as a taxable dividend to the individual shareholder.

Practitioners need to be extremely cautious when contemplating the payment of inter-corporate dividends as s. 55 contains some of the most complex rules in the *ITA*.

Section 55(3)(a) provides a very limited exception to s. 55(2) that permits dividend-stripping transactions in some but not all intra-family transfers. By virtue of s. 55(3)(a), s. 55(2) generally does not apply to recharacterize as a capital gain a deemed dividend arising on the wind up, discontinuance, or reorganization of a business or the repurchase or redemption of a share (s. 84(2) and (3)), unless there is:

(1) a disposition of any property to any person who is unrelated to the corporation that received the dividend; or
(2) substantial increase in the interest in any corporation of any person who is unrelated to the corporation that received the dividend.

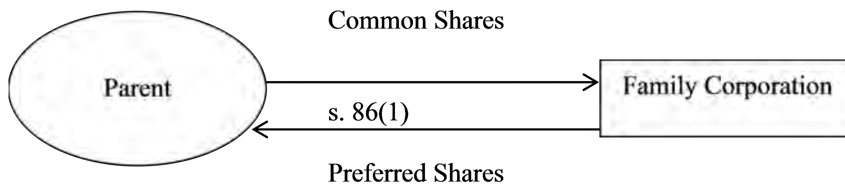
Pursuant to a private member's Bill C-208, which received Royal Assent on June 29, 2021, s. 55(5)(e)(i) no longer deems siblings to be dealing with each other at arm's length and not as related parties for the purposes of s. 55(2) where, in general terms, the dividend was received or paid by a corporation (the shares of which are QSBCS shares) or by a qualified family farm or fishing corporation. Siblings may now be able to benefit from s. 55(3)(a) in certain circumstances. However, see the comments regarding Bill C-208 in "Section 84.1 and Sales to Children as a Tax Savings Technique" in this chapter.

Section 55(3)(b) also provides a very complex exception to s. 55(2) in respect of true "butterfly" reorganizations. These are reorganizations in which each shareholder ends up with a proportionate share, owned through a corporation, of cash, investment assets, and business assets so that it cannot be said that any shareholder is being cashed out. Further continuity of shareholdings and continuity of the ownership of corporate asset requirements prohibit "purchase butterfly" transactions, which would otherwise permit a corporation to be split in two on a tax-deferred basis in anticipation of selling one of the corporations.

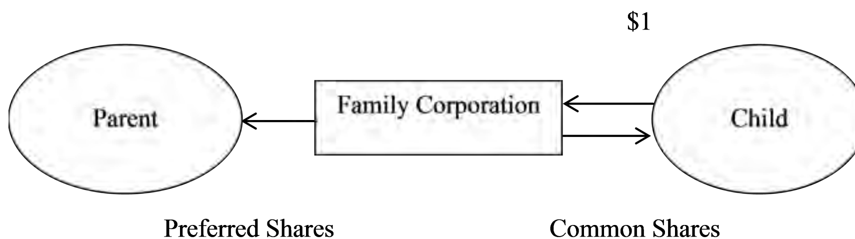
In the freeze context, s. 55(3)(a) will in many cases exclude the application of s. 55(2) if only close family members, including parents who control the family corporations, are involved. This is because, generally, no unrelated person will receive any property or increased interest in an unrelated corporation as a result of the transactions

or events. While there are many variations, a dividend-stripping transaction typically involves the following steps:

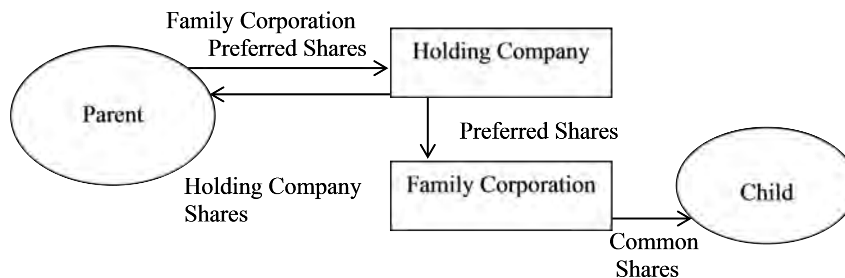
(1) the parent exchanges the common shares of the family corporation for voting preferred shares of the family corporation on a tax-free basis pursuant to s. 86(1);



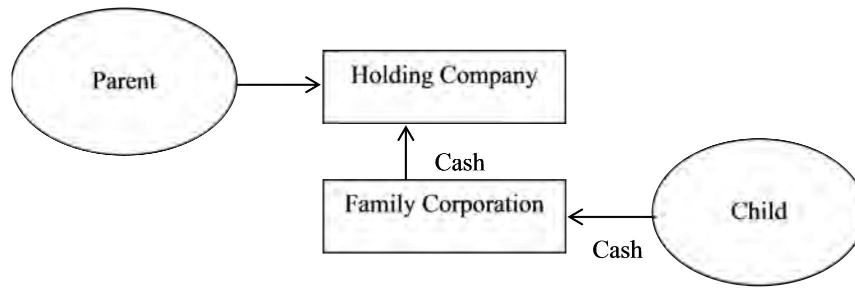
(2) the family corporation issues common shares to the child for nominal consideration entitling the child to all future growth in the value of the family corporation;



(3) the parent transfers the preferred shares of the family corporation to a holding corporation on a tax-free basis in consideration for the holding corporation's shares pursuant to s. 85(1); and



(4) the child lends the family corporation funds or the family corporation's future earnings are used to redeem its preferred shares held by the holding corporation.



As long as the parent leaves the redemption proceeds in the holding corporation, no tax is paid on the sale resulting in a deferral that is typically in the order of 25 cents per dollar of "sales proceeds".

In this example, provided that the exception in s. 55(5)(e)(i) applies and the dividend was paid or received by a corporation, the shares of which were QSBCS shares (as described above in the comments regarding Bill C-208), if the "vendor" was a sibling of the child rather than a parent, then the redemption proceeds received by the holding corporation could similarly flow as a tax free inter-corporate dividend rather than be taxed as the proceeds of disposition from the sale of the family corporation's preferred shares.

E. INTERESTS IN DISCRETIONARY TRUSTS [§1.15]

Discretionary trusts can be used to defer the imposition of tax in succession planning.

Successive interests in property can be established either formally by providing for fixed life and remainder interests, or informally by including family members from different generations as beneficiaries of a discretionary trust. If a trust is a discretionary trust, it is possible to argue that no single beneficiary's interest has any significant value, notwithstanding the fact that the trust's assets have a large value. The result is that no tax will be payable on the death of a beneficiary in respect of their interest in the trust. This does not avoid the deemed disposition of the interest in the trust immediately before the beneficiary's death, but it makes its impact irrelevant because the interest has little or no value. In *Gartside and Another v. Inland Revenue Commissioners*, [1968] 1 All E.R. 121 (H.L.), the House of Lords held that the interest of a beneficiary in a purely discretionary trust was incapable of being quantified. The nominal value of a