

**ESTATE FREEZES AND THE  
UNINCORPORATED REAL ESTATE OWNER**

by

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## **ABSTRACT**

So often it is the case that children when confronted with the death of their last surviving parent are also faced with the reality that a family's real estate assets must be sold in order to pay the taxes due on death. In many cases these properties have been held for years and not only represent a connection to the past, but more importantly a means of generating future family wealth.

This paper explores an option available to the unincorporated real estate owner that has the potential of lessening the tax burden on death and ensuring that family property remains in the family, while at the same time dramatically increasing family wealth as a whole.

While not for everyone, it is certainly an option worth investigating.

## **ACKNOWLEDGEMENTS**

I would like to acknowledge the time and effort of Dr. George Blazenko who volunteered to review and supervise this undertaking. I would also like to acknowledge the support of my employer, the City of Surrey.

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# 1 INTRODUCTION

The maximization and preservation of family wealth are common tax planning objectives. Also prevalent is the personal, as opposed to corporate, ownership of real property. With this in mind, this paper has been written with the view to introducing the unincorporated real estate owner to a tax planning option which may help to increase, or at least preserve, family wealth in the long-term. This paper is not, however, intended to replace the advice of a trained tax planning professional, but instead is intended to supplement such advice. Where the reader is inclined to pursue or recommend an estate freeze, the advice of a tax planning professional should be sought prior to an estate freeze being implemented.

This paper begins by introducing the reader to the concept of the estate freeze. This is followed by a detailed discussion of a subsection 85(1) “rollover” which plays an integral part of the estate freeze process. The discussion of the subsection 85(1) rollover then expands into a consideration of the requirement that the real property subject to the estate freeze be characterized as “capital” in nature. Factors relied upon by the Courts and the Canada Customs and Revenue Agency (the “CCRA”) in support of the characterization of real property as “capital” are reviewed. This then is followed by a discussion of general considerations that should be assessed when contemplating an estate freeze. The reader is also introduced to various real property valuation methodologies, which may be

used to ascertain the underlying fair market value of the preferred shares that are issued to the freezor (in this case the "Parent(s)") in exchange for the real property in the estate freeze process. These include the Cost Approach, the Income Approach and the Direct Comparison Approach.

With a focus on the unincorporated real estate owner, this paper also develops a valuation model which quantifies the value of an estate freeze. In so doing, various other topics which have the potential to impact the value of an estate freeze are reviewed. In developing the valuation model, the author builds upon a model developed by Ling Chu, Glenn Feltham and Robert Mathieu (2001).<sup>1</sup>

To conclude, the valuation model developed is applied to selected fact situations with a view to determining whether there is any financial incentive or net benefit in proceeding with an estate freeze.

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<sup>1</sup>Ling Chu, Glenn Feltham, and Robert Mathieu, "The Deferral Value of Estate Freezes," *The Canadian Tax Journal* (2001): Vol. 49, No. 2

## 2 THE ESTATE FREEZE

An estate freeze is a tax planning technique whereby a taxpayer (for our purposes the “Parent(s)”) fixes or “freezes” the value of his or her estate (property), and ensures that any future appreciation in the value of the property accrues to the benefit of family members; most often his or her children.<sup>2</sup>

The primary objective of an estate freeze is to limit the potential tax cost arising on death by virtue of the “deemed disposition” rules under subsection 70(5) of the Income Tax Act.<sup>3</sup> These rules provide that the Parent is deemed, immediately before death, to have disposed of all capital property owned, and to have received proceeds of disposition equal to the fair market value of the property (subsection 70(5)(a)). Similarly, the person acquiring such property is deemed to have acquired the property immediately before death at a cost equal to its fair market value (subsection 70(5)(b)).<sup>4</sup>

Put simply, an estate freeze is achieved by exchanging the property that is expected to increase in value for property that will not increase in value. The intended beneficiaries of the freeze, in this case the children, are then effectively given (through ownership of

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<sup>2</sup> Richard J. Bennett, “Tax Rollovers for General Practitioners,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax Rollovers for General Practitioners, Vancouver, BC, October 5, 1995), 1.07

<sup>3</sup> Ross D. Tunnicliffe, “Estate Planning for Aging Clients” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Estate Planning for Aging Clients, Vancouver, BC, Canada, October 18, 1999), 4.1.08

<sup>4</sup> William S. Maclagan and Michael Coburn, “Tax for the Non-Specialist - 2003 Update,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the General Practitioner, Vancouver, BC, February 21, 2003), 6.1.05

shares) the property that is expected to increase in value.<sup>5</sup> Using a more technical explanation, a freeze may be achieved by transferring property to a holding corporation by way of a subsection 85(1) rollover. The Parent (who is the transferor) takes back preferred shares, which are retractable by the Parent and redeemable by the corporation, in exchange for the property. The preferred shares have a fixed redemption and retraction price equal to the fair market value (as at the date of the freeze) of the property transferred to the corporation. Common shares, having nominal value (usually \$1.00), are then issued to the children as the intended beneficiaries of the estate freeze. As the preferred shares are for fixed value, any future growth accumulates to the benefit of the common shares of the holding corporation which are held by the children. In this way, upon the death of the Parent, the Parent will only be deemed to have disposed of the preferred shares, which are fixed or “frozen” in value.<sup>6</sup> Consequently, the tax liability payable upon the death of the Parent is capped.

The following example serves to clarify the above explanation:

John Smith owns a parcel of real estate which has a fair market value of \$2,000,000 and an adjusted cost base (the tax cost) of \$800,000. He anticipates that the property’s value will escalate dramatically in the near future and wishes to implement an estate freeze. John does not want to trigger any immediate tax

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<sup>5</sup> Gregory T.W. Bowden, “Tax for the Non-Specialist –2002,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Red Flags in Tax, Vancouver BC, Canada, June 20 2002),1.1.15

<sup>6</sup> Ross D. Tunnicliffe, “Estate Planning for Aging Clients” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Estate Planning for Aging Clients, Vancouver, BC, Canada, October 18, 1999),4.1.08; Gregory T.W. Bowden, “Tax for the Non-Specialist – 2002,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Red Flags in Tax, Vancouver BC, Canada, June 20 2002), 1.1.15

liability and would like his children Edward and Mary to benefit from the anticipated future growth in value of the property.

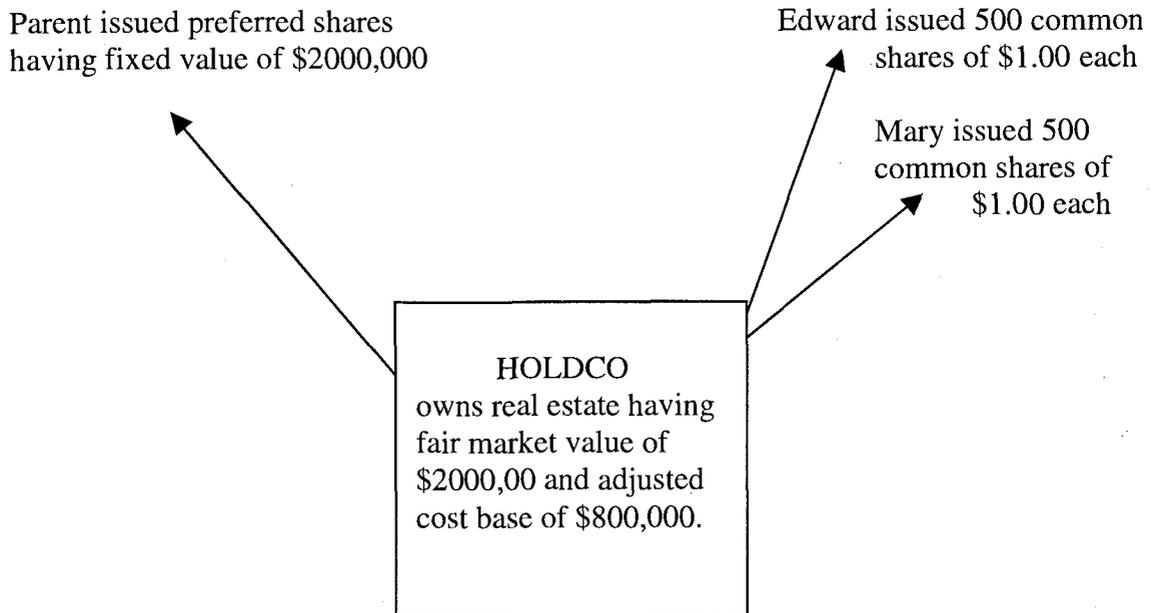
John proceeds to incorporate a corporation (Holdco) and uses a subsection 85(1) rollover to transfer the property to Holdco in exchange for preferred shares having a fixed value of \$2,000,000. Common shares are then issued to Edward and Mary for a nominal amount, say 500 shares each for \$1.00 per share.

Using a subsection 85(1) rollover, John is able to transfer the property to Holdco at the tax cost amount of the property, i.e. \$800,000. In this way no capital gain arises and John does not trigger a taxable disposition.

After the estate freeze is implemented, John will have preferred shares of Holdco with a fixed value of \$2,000,000; the children, Edward and Mary, will hold common shares now equal to \$1.00 each, but which will increase in value over time as the property now held by Holdco grows in value; and the property transferred to Holdco appears on Holdco's books as having a fair market value of \$2,000,000 and a tax cost or adjusted cost base of \$800,000.

Figure 1 illustrates the end result of the estate freeze described above:

**Figure 1: The End Result of an Estate Freeze**



## 2.1 The Preferred Shares

By making the preferred shares retractable by the Parent at any time following the estate freeze, a lower limit is effectively placed on the value of the preferred shares. In other words, the preferred shares cannot be worth less than the redemption amount as the Parent has the absolute right to receive that amount. Similarly, an upper limit is placed

on the value of the preferred shares by allowing the corporation to redeem the preferred shares at this same fixed value.<sup>7</sup>

In order to satisfy requirements of the CCRA, the preferred shares should also have the following characteristics:

1. *“redeemable at the option of the holder;*
2. *the right to vote in relation to matters affecting the preferred shares;*
3. *priority on the distribution of assets on liquidation or winding-up;*
4. *no restriction on transferability, other than normal corporate law requirements; and*
5. *include a restriction on the payments of dividends on other shares if doing so would impair the ability of the corporation to redeem the preferred shares for their redemption price.”*<sup>8</sup>

## **2.2 Increasing Family Wealth**

As mentioned, an estate freeze attempts to minimize tax that would otherwise be payable upon death of the Parent by ensuring that the value of the Parent’s estate will not increase after the freeze is implemented. In effect, an estate freeze fixes the value of the Parent’s interest in the property at a particular date; changes in value subsequent to that date (i.e. future growth) accumulate to the children.<sup>9</sup> What results is a deferral of tax that

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<sup>7</sup> Glenn D. Feltham and Robert Mathieu, “Handbook Section 3860 and Estate Freezes” (paper prepared for the Certified General Accountants Association of Canada, Vancouver, BC: Canada, 1999), 3

<sup>8</sup> Gregory T.W. Bowden, “Tax for the Non-Specialist –2002,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Red Flags in Tax, Vancouver BC, Canada, June 20 2002),1.1.15; Ross D. Tunnicliffe, “Estate Planning for Aging Clients” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Estate Planning for Aging Clients, Vancouver, BC, Canada, October 18, 1999),4.1.08

<sup>9</sup> Catherine Brown, and Cindy Radu, *Taxation and Estate Planning*. (Toronto, Ontario: Canada: Carswell, 1996), 7.1

would otherwise have been payable in the hands of the Parent. The value of this deferral is what motivates a Parent to implement an estate freeze. Building upon a model developed by Ling Chu, Glenn Felthman and Robert Mathieu (the “Valuation Model”), the deferral value of an estate freeze can be quantified.<sup>10</sup> This quantification in the real estate context is undertaken in this paper for selected fact situations.

For the purposes of this paper, the value of an estate freeze is defined as the value of deferring the payment of tax on future growth, that is, the value of having the children, rather than the parents, taxed on future growth. The objective, therefore, is to determine whether performing an estate freeze increases the after-tax future wealth of the family as a whole.

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<sup>10</sup> Ling Chu, Glenn Feltham, and Robert Mathieu, “The Deferral Value of Estate Freezes,” *The Canadian Tax Journal* (2001): Vol. 49, No. 2

### **3 TRANSFER OF ASSETS TO A HOLDING CORPORATION**

#### **3.1 Subsection 85(1) Rollover Introduced**

Fundamental to the implementation of an estate freeze is the utilization of a subsection 85 (1) rollover. To appreciate the significance of this tool, the tax consequences in the absence of a rollover must first be considered.

Normally, a taxpayer transferring property to a corporation for proceeds in excess of the cost of the property will realize a gain which must be included in computing the taxpayer's income. Depending upon the nature of the property, the gain may be treated as income, recapture or a capital gain. In those instances where the property transferred is, for the purposes of the Income Tax Act, considered inventory or property held in the course of "an adventure or concern in the nature of trade"<sup>11</sup>, the total gain must be included in the taxpayer's income. In contrast, if the gain arises from the disposition of capital property, only 50% of the gain will be included in the taxpayer's income. Where the taxpayer disposes of depreciable capital property, the taxpayer may realize recapture of previously claimed capital cost allowance.<sup>12</sup>

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<sup>11</sup> s 248(1) of the Income Tax Act defines "business" to include an "adventure or concern in the nature of trade".

<sup>12</sup> David R. Baxter, "Tax Issues for Solicitors" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.20; Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.05

To address the situation where the transferor and the corporation do not deal at arm's length, section 69 of the Income Tax Act will deem the transferor to receive proceeds of disposition equal to the fair market value (the "FMV") of the transferred property.

Whether or not the transferor actually received FMV is immaterial - it is the amount by which the FMV of the transferred property exceeds its cost amount that will be the gain subject to tax. For example, if the transfer occurs by way of gift, the corporation will still be deemed to acquire the property at a cost equal to its FMV. The same would apply where the corporation pays something less than FMV.<sup>13</sup>

In many cases, the transferor will want to defer recognition of any gain that would otherwise be realized on a transfer of property to a corporation. By allowing a "rollover", subsection 85(1) overrides the general rule and provides for a deferral of tax on the transfer of assets to a corporation where all of the conditions of the subsection are satisfied. Where the transferor satisfies these conditions, the transferor and the corporation are able to elect an amount/value at which the the property will be transferred to the corporation (the "Elected Amount") that, for income tax purposes, will be deemed to be the transferor's proceeds of disposition and the corporation's tax cost of the property. The transferor will not recognize a gain or recapture from the disposition for

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<sup>13</sup> David R. Baxter, "Tax Issues for Solicitors" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.20; Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.05 and 3.1.12 to 3.1.13; Gregory T.W. Bowden, "Tax for the Non-Specialist -2002," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Red Flags in Tax, Vancouver BC, Canada, June 20 2002), 1.1.06; Barry MacDonald, "Pre-Death Planning - Doing an Estate Freeze - The Accountant's Perspective," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.05

income tax purposes unless the Elected Amount is greater than the cost amount of the property to the transferor.<sup>14</sup>

In other words, a rollover occurs when property passes from one person or entity to another in a transaction that is a “disposition” (or deemed disposition) without triggering a taxable event.<sup>15</sup> In effect, a rollover allows the transferor to avoid the transfer being characterized as a taxable disposition.<sup>16</sup>

As mentioned, when a subsection 85(1) rollover is utilized, the corporation is deemed to acquire the transferred property at the Elected Amount. Consequently, when the corporation in future disposes of the property, its gain will be the amount by which the proceeds received exceed the Elected Amount. The effect of the subsection 85(1) rollover, therefore, is to defer the tax which would otherwise have been payable by the transferor had the transfer of assets to the corporation taken place on a fully taxable basis at FMV.<sup>17</sup>

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<sup>14</sup> David R. Baxter, “Tax Issues for Solicitors” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Solicitors’ Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.20; Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.05

<sup>15</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 399

<sup>16</sup> Richard J. Bennett, “Tax Rollovers for General Practitioners,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax Rollovers for General Practitioners, Vancouver, BC, October 5, 1995), 1.01

<sup>17</sup> David R. Baxter, “Tax Issues for Solicitors” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Solicitors’ Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.20; Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.05; John R. Owen, and Paul J. Gibney, “Income Tax Law for Non-Specialists,” (material presented at the Osgoode Hall Law School of York University Professional Development Programme, Ontario, BC, January 21-22, 1999), 4

The example below further clarifies the deferral effect of transferring property on a subsection 85(1) basis:

*“Assume a transferor sells to a corporation, for \$100 share consideration, property which has a tax cost to the transferor of \$50 and FMV of \$100. Absent a rollover, the sale would give rise to a gain of \$50 (\$100 - \$50) in the transferor’s hands, which would have to be taken into account by the transferor when computing his income for the year in which the transfer occurred. The tax treatment depends on the nature of the property sold (i.e. capital property/depreciable property/inventory). If the transfer is effected under subsection 85(1), the transferor and the corporation may elect to have the transfer occur for deemed proceeds of \$50. In this event, no gain would be triggered by the transferor on the disposition of the property. ...The accrued gain on the property is preserved in the hands of the corporation, and the cost to the transferor of the consideration received is limited to the cost of the property transferred. Accordingly, to the extent the accrued gain on the property is not recognized by the transferor by reason of a subsection 85(1) election, it will ultimately be recognized when the corporation disposes of the property or the transferor disposes of the share consideration received from the corporation.”<sup>18</sup>*

### **3.2 Eligible Property**

Not all types of property can be transferred via a subsection 85(1) rollover. Only “eligible property” as defined in subsection 85(1.1) can be transferred to a taxable Canadian corporation on a rollover basis if the transferor receives consideration that includes shares of the transferee corporation.<sup>19</sup> The transferor can be a corporation or an individual. In

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<sup>18</sup> Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.06

<sup>19</sup> *Canadian Master Tax Guide*, 59<sup>th</sup> Edition. (Toronto, Ontario: Canada: CCH Canadian Limited, 2004), 536

order for subsection 85(1) to apply, the transferor and the corporation must jointly elect on form T2057.<sup>20</sup>

Subsection 85 (1.1) defines “eligible property” to mean:

- (i) *“a capital property (except that real property or an interest or option therein owned by a non-resident person is generally not eligible property);*
- (ii) *a Canadian or foreign resource property;*
- (iii) *an eligible capital property (such as goodwill);*
- (iv) *inventory, but not including real property that is inventory; or*
- (v) *property (other than capital property or inventory) that is security or debt obligation used by the taxpayer in the year, or held by the taxpayer in the year, in the course of carrying on a business of insurance or lending money.”<sup>21</sup>*

Given that a subsection 85(1) rollover is fundamental to the implementation of an estate freeze, caution must be exercised in determining that the property to be transferred to the holding corporation is, in fact, “eligible property” as defined. The determination of whether real property is “eligible property” is not always straightforward. As set out in subsection 85(1.1), real property will qualify as “eligible property” if it is a capital property that is:

- *“Owned by a resident of Canada;*
- *Owned by a non-resident insurer provided that the property, and the consideration received for it, are used or held by the insurer in the course of carrying on an insurance business in Canada; or*

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<sup>20</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989), 55-055; *British Columbia Estate Planning and Wealth Preservation*, 2003 Update (British Columbia: Canada: The Continuing Legal Education Society of British Columbia, 2002), 2-4

<sup>21</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989), 31,152

- *Owned by any other non-resident person provided that the property is used by the non-resident person in carrying on a business in Canada.*<sup>22</sup>

In the real estate context, a significant limitation of the definition of eligible property is the provision that real property that is considered inventory is not eligible for a subsection 85(1) rollover.<sup>23</sup>

Distinguishing real estate held as capital property from real estate held as inventory can present a challenge, particularly if the taxpayer's intentions with respect to the property are not clear. A discussion of the distinction between real property that is capital property and real property that is not capital property is thoroughly canvassed in Section 4 of this paper. Having said this, following general guidelines were identified by John R. Owen and Paul J. Gibney in a paper presented at a Continuing Legal Education Seminar:

- *“Property that is held with the primary intention of resale at a profit is not capital;*
- *Generally, a taxpayer's intention with respect to a particular property is determined from the surrounding circumstances;*
- *Property that is held long term, particularly if it is used as a rental property or a personal use property, is more likely to be regarded as capital property;*
- *Property that is held short term, particularly if it is highly levered, is more likely to be regarded as non-capital property;*

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<sup>22</sup> David R. Baxter, “Tax Issues for Solicitors” (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.21; John R. Owen, and Paul J. Gibney, “Income Tax Law for Non-Specialists,” (material presented at the Osgoode Hall Law School of York University Professional Development Programme, Ontario, BC, January 21-22, 1999), 6

<sup>23</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989),55-055; Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999),3.1.07 to 3.1.08

- *The more frequently a person buys and sells property, the more likely that any particular property, will, in the absence of evidence to the contrary, be regarded as non-capital property.*<sup>24</sup>

In that same paper, it was also noted that particularly tough judgment calls may have to be made where a taxpayer, decides to develop for resale a vacant piece of land which has been owned for a long period of time.<sup>25</sup>

The reader should also be cautioned that in some cases real estate will be acquired as a capital property and subsequently converted into inventory before the transfer to a corporation takes place. The significance of this is that where the real estate originally held as capital has been converted to inventory, a rollover is no longer possible despite the fact that the property may have previously been capital property to the transferor.<sup>26</sup> In this regard, the reader will recall that the definition of eligible property as set out in subsection 85(1.1) expressly excludes real estate that is considered inventory under the Income Tax Act.

### **3.3 Consideration Received – (Share/Non-Share Consideration)**

In addition to the condition that the property transferred pursuant to a subsection 85(1) rollover be “eligible property”, another condition that must be satisfied when using subsection 85(1) is the requirement that the consideration received by the transferor from

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<sup>24</sup> John R. Owen, and Paul J. Gibney, “Income Tax Law for Non-Specialists,” (material presented at the Osgoode Hall Law School of York University Professional Development Programme, Ontario, BC, January 21-22, 1999), 7

<sup>25</sup> John R. Owen, and Paul J. Gibney, “Income Tax Law for Non-Specialists,” , 7

<sup>26</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989), 31,153

the corporation must include shares of the corporation. This rule applies to each separate asset transferred. The consideration received from the corporation may also include non-share consideration, such as a promissory note or the assumption of liability.<sup>27</sup> However, for the purposes of the analysis of selected fact situations that follow in this paper, it will be assumed that the consideration received by the Parent is limited to preferred shares which is consistent with a standard/basic estate freeze.<sup>28</sup>

### 3.4 Agreed or Elected Amount

Under normal circumstances, the Elected Amount selected by the transferor and the transferee is the cost amount to the transferor of the property to be transferred.<sup>29</sup> Such an election ensures that no income, capital gain or recapture is realized on the transfer of the property. In some situations, however, an Elected Amount higher than the cost amount, but less than FMV, may purposely be selected in order to create gains or recapture to offset existing losses.<sup>30</sup> For example, a transferor may choose an Elected Amount higher than FMV to take advantage of an available capital gains exemption.<sup>31</sup> In the context of real property of the unincorporated real property owner, this could occur in the case of

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<sup>27</sup> *British Columbia Estate Planning and Wealth Preservation*, 2003 Update (British Columbia: Canada: The Continuing Legal Education Society of British Columbia, 2002), 2-4; Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.09

<sup>28</sup> *British Columbia Estate Planning and Wealth Preservation*, 2003 Update (British Columbia: Canada: The Continuing Legal Education Society of British Columbia, 2002), 2-4

<sup>29</sup> John R. Owen, and Paul J. Gibney, "Income Tax Law for Non-Specialists," 11

<sup>30</sup> John R. Owen, and Paul J. Gibney, "Income Tax Law for Non-Specialists," 11

<sup>31</sup> Barry MacDonald, "Pre-Death Planning – Doing an Estate Freeze – The Accountant's Perspective," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.01

“Qualified Farm Property” which is eligible for a \$500,000 lifetime capital gains exemption.

In determining the Elected Amount, the Income Tax Act contains a number of rules and limitations. Two general limitations have been succinctly described in a paper presented by Steven M. Cook at a Continuing Legal Education seminar:

- (i) *“unless the next limitation applies, the minimum elected amount that may be chosen is the FMV of the non-share consideration (commonly referred to as “boot”) received from the corporation. As noted, boot may be cash, other property of the corporation, a promissory note of the corporation or the assumption by the corporation of a liability of the transferor. If the FMV of the boot is greater than the elected amount, the elected amount is automatically increased to the FMV of the boot; and*
  
- (ii) *the maximum elected amount that may be chosen for a particular property is the FMV of that property. If the FMV of the property is less than the chosen elected amount, the elected amount will automatically be adjusted downward to the FMV of the property.”<sup>32</sup>*

As expressly stated above, the second limitation overrides the first, so that if the value of the boot received exceeds the value of the transferred assets, the deemed proceeds to the transferor and cost to the corporation of the transferred assets are reduced to the FMV of the transferred property despite the receipt by the transferor of the more valuable boot. In this situation, the amount by which the value of the consideration received by the transferor exceeds the value of the transferred assets will likely be included in the

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<sup>32</sup> Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.09

transferor's income as a shareholder benefit.<sup>33</sup> It is also noteworthy that the general description of limitations set out above is consistent with that found in paragraphs 9 and 10 of CCRA Interpretation Bulletin IT 291R2.

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<sup>33</sup> David R. Baxter, "Tax Issues for Solicitors" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.20; Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.05 and 3.1.12 to 3.1.13; Gregory T.W. Bowden, "Tax for the Non-Specialist -2002," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Red Flags in Tax, Vancouver BC, Canada, June 20 2002), 1.1.06; Barry MacDonald, "Pre-Death Planning - Doing an Estate Freeze - The Accountant's Perspective," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.05

## 4 SATISFYING THE REQUIREMENT THAT REAL PROPERTY BE “CAPITAL”

The distinction between real property held on account of capital and real property held on account of income is significant because real property held on account of income cannot be transferred to a corporation on a tax-deferred basis under subsection 85(1) of the Income Tax Act.<sup>34</sup> In this regard, the reader will recall that real estate that is considered capital under the Income Tax Act satisfies the definition of “eligible property” set out in subsection 85(1.1) referred to earlier. Consequently, a Parent wishing to transfer real property on a rollover basis must ensure that the real property to be transferred under subsection 85(1) of the Income Tax Act is considered “capital”.

In order to understand what constitutes capital, it is first necessary to understand the distinction between capital gain and income. This distinction becomes apparent when one considers the difference between Investing and Trading. A thorough analysis of this topic is contained in the recent text authored by Peter W. Hogg, Joanne E. Magee and Jinyan Li.<sup>35</sup>

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<sup>34</sup> Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 8.3.01

<sup>35</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002)

## **4.1 INVESTING AND TRADING**

### **4.1.1 Real Property Held as Capital or Income**

#### **4.1.1.1 Importance of Characterization**

Profit from the sale of real property may be either characterized as a capital gain or income from business. How the profit is characterized is important because the Income Tax Act gives preferential treatment to capital gains. Currently capital gains are only 50% taxable, whereas income from business is fully taxable. Given these tax implications, it is not surprising that a frequently litigated issue is whether a profit realized from the sale of real property is a capital gain or income from business.

#### **4.1.1.2 Distinguishing between Investing (which implies capital gain) and Trading (which implies business income)**

The definition of a “capital gain” in paragraph 39(1)(a) of the Income Tax Act says, in effect, that a capital gain is a gain arising from the disposition of property which would not be taxed as ordinary income.<sup>36</sup> This is not particularly insightful. Proceeding then to income from a business, we find that “business” is defined in subsection 248(1) to include a “trade” or “an adventure or concern in the nature of trade”.<sup>37</sup> There are, however, no definitions of “trade” or “adventure or concern in the nature of trade”. This

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<sup>36</sup> Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.02

<sup>37</sup> Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 8.3.04

being the case, the characterization of what constitutes capital gain and what constitutes income from business is by default left to the courts.<sup>38</sup>

From the court decisions (case law), the characterization appears to rely upon an assumption that income must be a yield from a productive source. In most cases, the characterization is relatively simple: where property is purchased for some purpose other than resale (trading) then any gain realized when the property is eventually sold is not ordinary income. In other words, the profit on the sale of an investment, or on property used for personal consumption or on an income-producing business asset is characterized as capital gain. Whereas the sale of inventory property or speculative property is characterized as business income. The key, therefore, is to distinguish between “trading” and “investing” while at the same time recognizing that trading can be “systemic” or “speculative”.<sup>39</sup>

#### **4.1.2 Trade (as an aspect of the definition of “business” in s. 248(1))**

Considering the “trade” aspect of the definition of “business”, the following observations can be made:

##### **4.1.2.1 Systemic Buying and Selling and the Relationship to a Taxpayer’s Other Work**

Even if trading in real property is not a taxpayer’s main line of business, anyone who buys and sells real property in pursuit of profit is a trader. Consequently, the profit

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<sup>38</sup> *Canadian Master Tax Guide*, 59<sup>th</sup> Edition. (Toronto, Ontario: Canada: CCH Canadian Limited, 2004), 425 to 426

<sup>39</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 339

derived from such trading is considered income from business. Recognizing that a relationship to a taxpayer's main line of work is not required, it is noteworthy that a stronger inference will be drawn that an individual is engaged in trading if the buying and selling of real estate is related to the taxpayer's work.<sup>40</sup>

#### **4.1.2.2 Inventory**

Real property that has been purchased for resale as part of a business is inventory, whereas property that is used in a business to produce income over a period of time (buildings, machinery, vehicles, etc.) is depreciable property. A profit on the sale of inventory is income from business, but the sale of depreciable property is a capital gain as is profit on the sale of land used in a business (which is non-depreciable property).

Having said this, the reader should be aware that there are no comprehensive rules in the Income Tax Act for determining whether property is of a capital nature or inventory. In the event of a dispute, the determination of this issue has been left to the courts.<sup>41</sup>

Within a business, existing capital property may also be converted into inventory in certain circumstances. On this point, there is some jurisprudence that considers the factors relevant in determining whether such a conversion has occurred. In all cases, however, it is apparent that the issue of whether capital property has been converted into inventory is a question of fact to be determined on a case-by case basis. The cases,

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<sup>40</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 340

<sup>41</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989), 10,051

though not entirely consistent, do provide some guidance to those called upon to express an opinion on whether a conversion from capital to inventory has taken place:

In *Moluch v. M.N.R.*, 66 DTC 5463 (Ex.Ct.), the taxpayer acquired 55 acres of vacant bush land, part of which he cleared and used as a farm. Approximately 10 years after the acquisition, the taxpayer's wife deteriorated in health and he decided to subdivide the land into residential lots. In doing so, he constructed improvements on the land including roads, sewers and utility connections. He also proceeded to advertise the lots for sale. The Court concluded that the taxpayer displayed business-like activity in changing the character of the raw land to that of serviced lots through the expenditure of considerable money and effort. The Court also considered that he had embarked on a new type of activity, namely, the land development business. As a result, it was determined that the taxpayer had converted his farm from capital property to inventory held in the course of carrying on a land development business. The Court recognized that the taxpayer brought the lots into inventory for tax purposes at their fair market value at the time of conversion.

The decision in *Moluch v. M.N.R.* should be compared with the earlier decision of the Exchequer Court in *McGuire v. M.N.R.*, 56 DTC 1024 (Ex.Ct.). In the *McGuire* case, a taxpayer purchased a farm, which he worked for several years until it became unprofitable. Still desiring to live there, he decided to sell that portion of the land he no longer required. The taxpayer subdivided the property into 52 lots and sold the lots. The Court held that the gains realized on the sale of the lots were on account of capital as the taxpayer had not transformed the farm (i.e. capital property) into inventory. It was

maintained that the subdivision of the farm and the sale of individual lots were considered an expedient method of disposing of the farm. According to the Court, it was immaterial whether he sold the land as a whole or in subdivided parcels.

To reconcile these two decisions, it is noteworthy that the taxpayer in the Moluch case, in addition to subdividing the land, constructed improvements such as roads, sewers and utilities. In this regard, the degree of business-like activity displayed by the taxpayer in the Moluch case was greater than that displayed by the taxpayer in the McGuire case.

The McGuire case was followed in *Hayes v. M.N.R.*, 89 DTC 334 (T.C.C.), where the Court found that the lack of business organization and a business plan resulted in a capital gains treatment on the sale of lots. The activities of the taxpayer were essentially limited to the registration of plans for the subdivision of the lands. The McGuire decision was also followed in *Holmes v. M.N.R.*, 82 DTC 1010 (T.R.B.). In the Holmes case, the taxpayer, after approximately 50 years of farming, commenced to dispose of portions of his farmland. The Board decided that the filing of a subdivision plan did not, in itself, convert farmland to business inventory and thus the gain on the sale of the lots did not lose its characterization as capital gain. Similar to the McGuire case, the fact that the lots were unserviced supported the view that the property retained its capital nature after the subdivision.

It appears from the Moluch, McGuire, Hayes and Holmes cases that subdivision of land does not, in isolation, convert capital into inventory. It seems something more is required such as improvements like roads, sewers and utilities to the land, before a conversion is

triggered. In other words, there must be additional improvements or the indicia of a business operation before the taxpayer will be considered to have converted the land from a capital asset to a trading asset.

Somewhat at odds with the McGuire line of cases is that of Highland-Young Associates Limited v. M.N.R., 81 DTC 531 (T.R.B.). In that case a corporate taxpayer's plans for an 18-hole golf course were later downsized to a nine-hole golf course. The taxpayer then decided to subdivide the excess lands into residential lots. The Tax Review Board held that this change in business intention was sufficient to convert those lands that were set aside for residential purposes from capital property to inventory at the time the intention and decision to develop a residential housing project materialized, which in this case occurred when a plan of subdivision was submitted to the planning authority.

In addition to referring to cases that have addressed the issue, consideration should also be given to the CCRA's Interpretation Bulletins. On this point, Interpretation Bulletin IT 218R states that where a taxpayer disposes of land that he used in a farming business, or land acquired by inheritance, and where, in the course of disposing of that property, the taxpayer goes beyond mere subdivision of the land and makes improvements (such as water mains, sewers, and roads) or carries on an extensive advertising campaign to sell the lots, the taxpayer will be considered to have converted the land from capital property into trading property. The mere filing of a plan of subdivision does not convert capital property to inventory notwithstanding that such subdivision may enhance the value of such land (see Interpretation Bulletin IT-218-R, paragraphs 23 and 24). This view generally accords with the decisions in Moluch, McGuire, Holmes and Hayes cases.

Regarding Interpretation Bulletins in general, the reader should be cautioned that Interpretation Bulletins do not have the force of law and the CCRA is not estopped from adopting a position contrary to that expressly set out in the bulletin. While this is unlikely, it is not inconceivable.<sup>42</sup>

#### **4.1.3 Adventure In the Nature of Trade (another aspect of the definition of “business”)**

Turning to the another aspect of the definition of “business” identified in s. 248 (1) of the Income Tax Act, i.e. “an adventure or concern in the nature of trade”, it is observed that real property that would otherwise be considered capital may instead be held to be on account of income if the circumstances in which the property is held amount to “an adventure in the nature of trade”.<sup>43</sup>

##### **4.1.3.1 Isolated Transaction**

“An adventure in the nature of trade” captures an isolated transaction that is speculative in nature. Accordingly, when a taxpayer enters into an isolated transaction (or only a few transactions), though he or she is not a trader; if the transaction was a speculative one,

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<sup>42</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 17

<sup>43</sup> Leonard Glass, “Tax for the Corporate Commercial Lawyer” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 8.3.04

intended to yield a profit, the profit will still be considered income from business rather than a capital gain.<sup>44</sup>

#### 4.1.3.2 Intention

- *Intention on acquisition*

The critical factor in distinguishing between “an adventure in the nature of trade” and an investment (capital property), is the taxpayer’s intention at the time the property is acquired. If, at that time, the taxpayer’s intention was to resell the property for a profit, then the transaction is “an adventure in the nature of trade” and any profit realized will be treated as business income. Where, however, the intention of the taxpayer was to retain the property as a source of regular income (or any purpose other than resale), then the transaction is an investment and any profit will instead be taxed as a capital gain.

Although many factors are considered in resolving the question of whether a transaction is “an adventure or concern in the nature of trade”, these factors are merely objective indicators of speculative intention. It is what the taxpayer actually intended and not what he should have reasonably expected or intended that is relevant.<sup>45</sup> These factors or indicators include: “*whether the property was acquired with borrowed funds; the period of ownership of the property; efforts made to attract purchasers or to make the property more marketable; the skill and experience of the taxpayer; the relationship of the transaction to the taxpayer’s ordinary business; the nature of the property, especially*

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<sup>44</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 341

<sup>45</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989), 10,153

*whether it yields regular income; and the circumstances of the eventual sale, especially whether it arose from something unanticipated at the time of purchase.”*<sup>46</sup>

The following cases, which are discussed in the CCH – Canadian Real Estate and Income Tax Guide<sup>47</sup> illustrate that the taxpayer’s intention is a question of fact and they provide some guidance for similar fact situations. The cases also reaffirm the view that the courts will have regard to the factual circumstances surrounding the ownership and disposition of real estate.

In *McIntosh v. M.N.R.*, 12 DTC 1021 (S.C.C.), the taxpayer participated in a scheme of acquiring vacant subdivision and building homes thereon. Four years after commencing, the taxpayer split with his partner and he decided to abandon the scheme. As a result, the taxpayer sold the remaining lots. The taxpayer contended that the profit was the result of the realization of an investment and was, therefore, a capital gain. The Supreme Court of Canada disagreed with the taxpayer and concluded that the entire record of dealings in lots made it clear that the profit from the sale of the lots was taxable as income from an adventure in the nature of trade. The Supreme Court found that the taxpayer’s intention from the beginning of the venture was to make a profit on the resale of the lots and not to retain the property as an investment. This intention was not altered by the change in circumstances surrounding the various phases of the transaction.

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<sup>46</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 342

<sup>47</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989)

In *Monfort Lake Estates Inc. v. The Queen*, 79 DTC 5467 (F.C.T.D.), the taxpayer corporation acquired a country estate as a long-term investment. In order to finance improvements to the estate some building lots were sold. After 17 years, the entire estate was sold in response to an attractive and unsolicited offer. Although the gains from the sale of building lots were held to be income, the gain from the sale of the estate itself was on capital account. It was held that the taxpayer was a trader with respect to the subdivided building lots, but not with respect to the rest of the estate property. The Court observed that a taxpayer could simultaneously trade in land and hold other land as a capital investment; the intentions being different with respect to the various properties.

In *Caribbean Properties Ltd. v. The Queen*, 74 DTC 6660 (F.C.T.D.), the taxpayer maintained that it had purchased 70 acres of farmland with the intention of converting it into a golf course. The taxpayer also maintained that there was no secondary intention to deal with it otherwise. The Court, however, rejected this position relying on evidence that indicated that no real inquiries had been made before the purchase to determine whether it made good business sense to acquire the land for a golf course. The Court also relied on the fact that after the acquisition was made, very little was done to develop the land as a golf course. The taxpayer failed to establish that the land was acquired for the purpose of developing a golf course to the exclusion of an alternative purpose of disposing of it. The Court found it extremely improbable that the group, led by a real estate broker, would not have contemplated resale of the land in the event that it would not be developed as a golf course. Consequently, the profit on the sale in response to an unsolicited offer was taxable as business income.

It would appear that the lack of implementation of an alleged investment intention was fatal and caused the Court to reject the taxpayer's claim that an investment intention did, in fact, exist. The courts have similarly held in other cases that a failure to implement a stated investment intention leads to an inference of trading intent.<sup>48</sup> In contrast, where a taxpayer's actions were consistent with an alleged intent in that there were bona fide attempts to implement the alleged intent, the courts have held the sale to be on capital account.<sup>49</sup>

In *M.N.R. v. Lawee et al*, 72 DTC 6342 (F.C.T.D.), the taxpayers sold non-revenue producing land after holding it for a period of nine years. It is noteworthy that the taxpayers had refused to sell the land when there was a boom in land development and had not dealt in real estate before that time. The Court held the profit on the sale to be on capital account. The Court found the sale was an isolated transaction and that their conduct with respect to the property was consistent with investment as a motive. The taxpayers' claim that the land was purchased for investment purposes was credible primarily on the evidence of their desire to place their money in a secure investment.

In *McDonald v. The Queen*, 74 DTC 6644 (F.C.A.), sufficient evidence was adduced to support the conclusion that the taxpayer's sole purpose in purchasing a share of vacant farm land was to realize a profit by resale at an opportune moment. An important finding in the decision was the annual income produced from the land was so negligible that it was clear the property was not acquired as an income-producing asset. The Court found

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<sup>48</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989), 10,154

<sup>49</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. ,10,155

the taxpayer's intention from the very beginning was to sell at a profit and as such the Court held that the transaction was "an adventure in the nature of trade" and the gain was taxable as business income. The characterization of the transaction as a speculative venture was in no way changed simply because the taxpayer intended to retain his interest in the land for a substantially longer period of time than he actually did.

In *M.N.R. v. Edgeley Farms Ltd.*, 69 DTC 5228 (S.C.C.), the taxpayer corporation in 1959 acquired 350 acres of farm land in a rapidly developing area. In 1960, the property was leased for 25 years to a tenant who was given the option to purchase the land in its entirety or in parcels of not less than 10 acres. In 1962, part of the land was sold at a profit pursuant to the option arrangement. In 1963, another profit was realized upon a partial expropriation. The Supreme Court of Canada held that the profits in 1962 and 1963 were taxable as business income. Although it had not been decided at the time of acquisition what use was to be made of the property, this indecision was soon resolved when the company gave the lease and the option a year after it had acquired the property. The option arrangement was all important as it was the method used by the corporation for carrying out its real estate transactions. The option gave the lessee the right to purchase the land in small parcels and provision had been made in the mortgage for the release of small parcels.

The decision of the Supreme Court of Canada in *M.N.R. v. Edgeley Farms Ltd.* is an example of the court inferring a speculative or trading intention at the outset by reason of

the location of the property in or near an expanding urban area. The Courts have on other occasions similarly relied on the location of property and found speculative intent.<sup>50</sup>

It is also not surprising that courts have on numerous occasions inferred speculative intent when profits were realized by taxpayers on a quick resale of real estate. In such instances the profit was held to be taxable as business income on the ground that the quick resale made it apparent that the taxpayer's intentions were speculative in nature.<sup>51</sup> Having said this, where the evidence did not support the inference, the Courts have also found profits derived from quick resales to be on capital account primarily on the basis that the evidence did not support the inference that the prospect of resale at a profit was a motivating reason for the purchase. The taxpayer's actions were simply dictated by good business sense and were what any prudent investor would have done given the sudden appreciation in value of the properties.<sup>52</sup> For example, a quick sale made for the purpose of delivering the taxpayer from financial difficulty was sufficient to characterize the transaction as on capital account. This occurred in the case of *Reicher v. The Queen* 76 DTC 6001 (F.C.A.), where it was found that the intention of the taxpayer and his associate was to obtain an office building for their business and that resale was not a motivating factor.

In *Froese v. The Queen*, 77 DTC 5364 (F.C.A.), the taxpayer acquired a nine and one-half acre parcel of land with the stated intention of building a shopping center. The area did not develop as rapidly as the taxpayer had expected. The result being that the

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<sup>50</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide.*, 10,156

<sup>51</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide.*, 10,157

<sup>52</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide.*, 10,157

taxpayer had acquired more land than was necessary for a shopping centre that could be sustained by the projected community development. As a result, the taxpayer sold seven excess acres, retaining the 2.2 acres most suitable for commercial development. The Federal Court of Appeal held the profit on the sale to be on capital account. The facts were consistent with the taxpayer's stated intention of holding the land as an investment and developing a shopping centre. The taxpayer had refused unsolicited offers to purchase the whole parcel and it was only after his subsequent realization that he had acquired too much land and that he was financially over committed that he decided to sell part of the parcel.

In *H. Fine and Sons v. M.N.R.*, 84 D.T.C. 6520 (Fed.T.D.), the taxpayer corporation purchased land and erected a warehouse on the site and transferred its business operations to the site. Several years later, the taxpayer experienced financial difficulties and was forced to sell off some of the land. In reporting income for the taxation year in question, the taxpayer reported the gain from sale of the land as a capital gain. The Federal Court-Trial Division agreed with the taxpayer. The taxpayer had purchased the new site as an investment for its business needs and not for a speculative purpose. Therefore, the transaction was not an adventure in the nature of trade, and the gain was on the account of capital.

Finally, in *Happy Valley Farms Ltd. v. The Queen*, 86 DTC 6421 (F.C.T.D.), the Court found that in determining whether the profit in a transaction was a capital gain or business income, the taxpayer's motive and whole course of conduct were key considerations. The factors to be considered include the nature of the property sold, the

length of the period of ownership, the frequency of similar transactions, the work expended on the property, the circumstances surrounding its sales and the underlying motive for the acquisition of the property. These factors have been considered frequently by the Courts in subsequent decisions as a basic framework of analysis. It is also noteworthy that many of these factors are also set out in Interpretation Bulletin IT 218R which is discussed later in this paper.

From a planning point of view, in terms of establishing intention, it would be prudent of the taxpayer, at the time of acquisition, to document his or her intention. This documentation could take the form of a letter or memorandum written by the taxpayer to file. Where the taxpayer is a corporation, its intention could be expressly stated in the recitals to directors' resolutions. This documentation may prove to be useful in the event the CCRA chooses to audit a future sale of the real property.<sup>53</sup>

- *Secondary intention*

A difficulty of relying on intention as the key to distinguishing between "an adventure in the nature of trade" (which implies income from business) and an investment (which implies capital gain) is that a taxpayer may have more than one intention at the time the subject property is acquired. This resulted in the development of the secondary intention doctrine. In those instances where property is purchased with the primary intention of using it in some non-speculative way and is also purchased with a secondary (alternative)

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<sup>53</sup> Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 8.3.03

intention of selling it at a profit in the event the primary purpose proves impracticable, then if the secondary intention is carried out the transaction will be held to be on account of income rather than capital. This occurred in the leading case of *Regal Heights v. M.N.R.*, [1960] S.C.R. 902, where the taxpayer acquired undeveloped land with the primary intention of building a shopping center on the site. After some development work had been done, the plan was abandoned when it was discovered that a major department store which the taxpayer intended to attract as a tenant had decided to locate in another shopping center to be built only two miles from the taxpayer's property. The taxpayer then sold the land at a profit. The Supreme Court of Canada accepted the trial judge's finding that the corporate taxpayer's primary intention was to develop the land into a shopping center and that there was a good chance that the shopping center plan might not materialize as there was no evidence that the taxpayer had any assurance when the land was acquired that it could interest a major department store, which is a necessity for a regional shopping centre. As such, the venture was entirely speculative. The taxpayer was held to have had a secondary intention to sell the land at a profit if the primary intention became impracticable. The Supreme Court of Canada, therefore, held that the existence of the secondary intention made the enterprise an adventure in the nature of trade and that the profit realized from the sale of the land was, therefore, income from business.

After the SCC decision in *Regal Heights*, the courts were frequently called upon to apply the doctrine of secondary intention. Although there was some inconsistency in its application, two decisions of the Federal Court of Appeal have provided a clearer understanding of the state of mind that will qualify as a secondary intention. The first

decision was *Reicher v. The Queen* 76 D.T.C. 6001 (Fed.C.A.). In that case, the taxpayer who was an engineer by profession, acquired land with partners to construct an office building. After the building was constructed, the taxpayer relocated and rented the remaining space to third parties. Approximately a year later, the taxpayer experienced financial difficulties and turned to his partners to buy his share. Unable to purchase his share, the building was sold at a profit and the taxpayer took back a lease from the purchaser. The taxpayer maintained that the sale and lease back was necessary because of financial difficulties that had unexpectedly arisen after the project was well under way. The Federal Court of Appeal accepted this explanation for the early sale and held that resale was not a motivating reason for the acquisition of the property. It was determined, therefore, that the transaction was not an adventure in the nature of trade.

The second decision was that of *Hiwako Investments v. The Queen*, 78 D.T.C. 6281 (Fed. C.A.). The taxpayer, less than a year after purchasing a group of apartment buildings, then sold them at a profit. Although the Federal Court of Appeal recognized that the taxpayer purchased the property for capital appreciation as well as the rental income, this alone did not amount to a secondary intention to sell. The Court determined that the secondary intention did not apply because the resale was not a motivating reason for the purchase of the apartments. Consequently, the transaction was not an adventure in the nature of trade.

From the decisions of *Reicher* and *Hiwako*, it appears that the secondary intention to sell must have existed at the time when the property was acquired, and that it must have been “an operating motivation” or a “motivating reason” for the acquisition of the property. A

secondary intention does not exist solely because the taxpayer contemplates, as any prudent investor would, the possibility of resale of the property. It has been suggested that the prospect of resale at a profit is a motivating reason only if the taxpayer would still have acquired the property as a speculation in the absence of the primary intention.<sup>54</sup> Certainly, however, the secondary intention doctrine will not be satisfied unless the prospect of resale at a profit was an important factor in the decision to acquire the property.

With the introduction of the secondary intention doctrine, the taxpayer faces an additional obstacle when seeking to establish that the disposition of real estate is a capital gain. Not only must the taxpayer adduce evidence to establish a primary intention to acquire an investment (i.e. a capital asset), but the CCRA's allegation of a secondary intention to trade must also be rebutted.

- *Change of intention*

Aside from the primary and secondary intention tests, a taxpayer may also face the argument that there has been a change of intention and that the characterization of the property has therefore changed from capital to inventory, or vice-versa. These decisions were discussed earlier under the subheading "Inventory".

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<sup>54</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 344

## 4.2 Interpretation Bulletin IT-218R

The CCRA has issued Interpretation Bulletin IT 218R dealing with the sale of real estate, wherein it purports to describe the general law and identify factors, to be taken into consideration when classifying real estate transactions:

*“ There is no provision in the Income Tax Act which describes the circumstances in which gains from the sale of real estate are to be determined as being either income or capital. However, in making such determinations, the courts have considered factors such as those listed below: (this is not intended to be exclusive of any other factors).*

- (a) the taxpayer’s intention with respect to the real estate at the time of its purchase;*
- (b) feasibility of the taxpayer’s intention;*
- (c) geographical location and zoned use of the real estate acquired;*
- (d) extent to which intention carried out by taxpayer;*
- (e) evidence that the taxpayer’s intention changed after purchase of the real estate;*
- (f) the nature of the business, professional calling or trade of the taxpayer and associates;*
- (g) the extent to which borrowed money was used to finance the real estate acquisition and the terms of financing, if any, arranged;*
- (h) the length of time throughout which the real estate was held by the taxpayer;*
- (i) the existence of persons other than the taxpayer who share interests in the real estate;*
- (j) the nature of the occupation of other persons referred to in (i) above as well as their stated intention and course of conduct;*
- (k) factors which motivated the sale of the real estate;*

(l) *evidence that the taxpayer and/or associates had dealt exclusively in real estate.*"<sup>55</sup>

Generally it is safe for a taxpayer to assume that an opinion expressed in an interpretation bulletin will be maintained by the CCRA. However, one should be mindful that interpretation bulletins are not legislation and accordingly do not have the force of law. Having said this, Courts do look at the bulletins as a persuasive aid to interpretation, but are not bound to follow them and often do not.<sup>56</sup>

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<sup>55</sup> Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 8.3.02

<sup>56</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 16 to 17

## **5 GENERAL CONSIDERATIONS**

### **5.1 General Considerations When Contemplating an Estate Freeze**

When contemplating an estate freeze there is a range of general considerations that must be taken into account:

#### **5.1.1 Future Economic Needs of the Parent**

Freezing a Parent's estate too early may cause significant hardship to the Parent. A Parent may, for example, later find that he or she has insufficient funds to maintain a standard of living which he or she finds acceptable. Therefore, prior to freezing the value of a Parent's property, one must assess whether there is sufficient income from other sources to provide the Parent with the lifestyle he or she wishes until the Parent's death. In making this assessment factors such as life expectancy and inflation must be considered.<sup>57</sup>

There may also be other planning opportunities within the general context of estate freezes available to the Parent to provide for such unexpected future cash needs. For example, the Parent could undertake a partial freeze or the Parent could freeze the current value of his or her estate and pass on its future growth to a discretionary family trust settled for the benefit of Parent and his or her children. Should the need for cash arise in

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<sup>57</sup> *Financial and Estate Planning for the Mature Client in British Columbia*, Issue 10, April 2004 (Markham Ontario: Canada: LexisNexis Canada Inc.2000), 8.39

the future, income or capital could then be distributed to the Parent from the family trust. These additional planning opportunities are, however, beyond the scope of this paper.

### **5.1.2 Valuing Assets to be Frozen**

In undertaking an estate freeze, a Parent will typically freeze the current value of the property which he or she expects will appreciate in the future, and passes on that future opportunity for growth in value to his or her children. As discussed earlier, it is essential to determine the fair market value ("FMV") of the property subject to the freeze in order to avoid the application of the indirect gift or shareholder benefit rules in the Income Tax Act which could disallow all or part of the tax deferral contemplated by the estate freeze.<sup>58</sup>

To assist in determining the meaning of FMV, reference can be made to CCRA's Interpretation Bulletin, IT-169: Price Adjustment Clauses. This interpretation bulletin defines the fair market value of an asset as the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being

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<sup>58</sup> Michael McMahon, "Tax Update - 2000," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax Update - 2000, Vancouver, BC, Canada, January 28, 2000), 1.1.05; David R. Baxter, "Tax Issues for Solicitors" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.20; Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.05 and 3.1.12 to 3.1.13; John R. Owen, and Paul J. Gibney, "Income Tax Law for Non-Specialists," (material presented at the Osgoode Hall Law School of York University Professional Development Programme, Ontario, BC, January 21-22, 1999), 1.1.06; Barry MacDonald, "Pre-Death Planning - Doing an Estate Freeze - The Accountant's Perspective," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.05

under any compulsion to transact. This definition is also consistent with other definitions of FMV.<sup>59</sup> Therefore, in valuing property subject to the freeze, the Parent must determine what amount an arm's length third party would pay for the asset in the open market.

Recognizing that there may be undesirable tax consequences, such as deemed shareholder benefits or indirect gifts included in the taxpayer's income, it is important to ensure that the FMV of assets transferred to a corporation under subsection 85(1) equals the FMV of the consideration paid by the corporation.<sup>60</sup> As a result, taxpayers frequently add a "price adjustment clause" to the rollover agreement, or to the share rights and restrictions.<sup>61</sup> What this clause attempts to do is expressly document the parties'

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<sup>59</sup> Steven M. Cook, "Tax for the Corporate Commercial Lawyer," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Vancouver, BC, Canada, June 1999), 3.1.03; Richard J. Bennett, "Tax Rollovers for General Practitioners," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax Rollovers for General Practitioners, Vancouver, BC, October 5, 1995), 1.03; *Canada Tax Words, Phrases & Rules*, 1999 Edition (Toronto, Ontario: Canada: Thomson Carswell, 1999), F-1

<sup>60</sup> Michael McMahon, "Tax Update – 2000," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax Update – 2000, Vancouver, BC, Canada, January 28, 2000), 1.1.05; David R. Baxter, "Tax Issues for Solicitors" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.20; Leonard Glass, "Tax for the Corporate Commercial Lawyer" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Tax for the Corporate Commercial Lawyer, Vancouver, BC, Canada, June 4, 1999), 3.1.05 and 3.1.12 to 3.1.13; John R. Owen, and Paul J. Gibney, "Income Tax Law for Non-Specialists," (material presented at the Osgoode Hall Law School of York University Professional Development Programme, Ontario, BC, January 21-22, 1999), 4; Gregory T.W. Bowden, "Tax for the Non-Specialist – 2002," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Red Flags in Tax, Vancouver BC, Canada, June 20 2002), 1.1.06; Barry MacDonald, "Pre-Death Planning – Doing an Estate Freeze – The Accountant's Perspective," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.05; Catherine Brown, and Cindy Radu, *Taxation and Estate Planning*. (Toronto, Ontario: Canada: Carswell, 1996), 7-9

<sup>61</sup> David R. Baxter, "Tax Issues for Solicitors" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.24 to 1.1.25; Barry MacDonald, "Pre-Death Planning – Doing an Estate Freeze – The Accountant's Perspective," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.06; *British Columbia Estate Planning and Wealth Preservation*, 2003 Update (British Columbia: Canada: The Continuing Legal Education Society of British Columbia, 2002), 2-12

intention to transact at FMV and obligates the parties to make appropriate adjustments if it is subsequently determined that the FMV is not equal to the consideration paid by the corporation pursuant to the section 85 agreement. It is the author's understanding that the CCRA's honours such clauses and permits the parties to make the necessary share price adjustments, provided that the parties made a bona fide attempt to determine FMV at the time of the transaction.<sup>62</sup> Consequently, the parties should have independent objective appraisal evidence of their determination of FMV in their files.<sup>63</sup> A formal appraisal from an accredited appraiser, while not a statutory requirement, will certainly provide evidence in support of the values chosen. It will also provide evidence that a bona fide attempt was made to determine FMV.

### **5.1.3 Control of Asset after the Estate Freeze**

In contemplation of an estate freeze, the Parent must determine if he or she wants to retain control over the freeze property until death or pass on the control at the time of the freeze to the children who are the beneficiaries of the estate freeze. Normally, the Parent will want to retain control over the freeze property during his or her lifetime. This can be

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<sup>62</sup> *Financial and Estate Planning for the Mature Client in British Columbia*, Issue 10, April 2004 (Markham Ontario: Canada: LexisNexis Canada Inc.2000), 8.46; David R. Baxter, "Tax Issues for Solicitors" (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Solicitors' Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.24 to 1.1.25; Barry MacDonald, "Pre-Death Planning – Doing an Estate Freeze – The Accountant's Perspective," (materials prepared for the Continuing Legal Education Society of BC's Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.06; *British Columbia Estate Planning and Wealth Preservation*, 2003 Update (British Columbia: Canada: The Continuing Legal Education Society of British Columbia, 2002), 2-12

<sup>63</sup> John R. Owen, and Paul J. Gibney, "Income Tax Law for Non-Specialists," (material presented at the Osgoode Hall Law School of York University Professional Development Programme, Ontario, BC, January 21-22, 1999), 12

accomplished by providing the Parent with all or with the majority of the voting shares of the corporation.

#### 5.1.4 Share Structure

The authorized share capital structure of the corporation in an estate freeze should include the following classes of shares with the following attributes:

1. *“a class of voting, non-participating shares which allows the holder to control the corporation after the freeze (e.g. 100 Class A voting, preferred shares issued at \$1.00 per share);*
2. *a class of non-voting, participating shares which entitles the holder to all future growth or increase in value of the corporation (e.g. 100 non-voting, participating common shares issued at \$1.00 per share); and*
3. *a class of preferred shares redeemable and retractable for an amount equal to the fair market value of the assets transferred to the corporation at the time of the freeze, less any non-share consideration paid by the corporation (e.g. Class B non-voting preferred shares with a total redemption value equal to the fair market value of the transferred assets).”<sup>64</sup>*

As a result of certain administrative guidelines of CCRA, special rights and restrictions should also be attached to the preferred shares. These were briefly identified in Section 2 of this paper.

It should also be noted that the above share structure can be simplified. On this point, the preferred shares in (3) above could be voting shares in which case the need for a separate class of shares with voting rights as in (1) above would be eliminated.

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<sup>64</sup> Barry MacDonald, “Pre-Death Planning – Doing an Estate Freeze – The Accountant’s Perspective,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Wills, Estates, and Trusts Conference, Vancouver, BC, Canada, June 4-5, 1998), 2.3.06

### **5.1.5 Costs Associated with an Estate Freeze**

In addition to the professional costs and expenses and implementation fees associated with implementing an estate freeze, a Parent must also consider other costs associated with an estate freeze itself. These costs may include property transfer tax, sales tax and goods and services tax. A more detailed discussion of applicable taxes and expenses is set out in a later section of this paper.

## **6 DETERMINING FMV OF REAL ESTATE FOR ESTATE FREEZE PURPOSES**

### **6.1 Fair Market Value and the Estate Freeze**

The importance of accurately assessing FMV in the context of an estate freeze cannot be overstated. As mentioned earlier, there are negative tax implications where the value of the consideration received by the Parent (i.e. the value of the preferred shares) is understated. It is for this reason that it is recommended that an accredited real estate appraiser be engaged to appraise the value of the property which is being contemplated for the freeze. Moreover, while price adjustment clauses are common, these clauses alone do not satisfy CCRA's requirement that the initial valuations be established on a bona-fide basis. It is submitted that an appraisal will, at a minimum, satisfy the requirement that the parties have made a bona-fide attempt to determine fair market value of the freeze property.

A basic understanding of appraisal methodologies, therefore, allows the parties to review an appraisal and be in a position to critique it or at least identify matters of subjective opinion which may dramatically affect the final determination of value and which may, in some circumstances, be revised if addressed directly with the appraiser. This does not mean the appraiser will rewrite his or her opinion, but he or she may take a more conservative or relaxed view of a matter if challenged on the point. After all, an appraisal

ultimately is a matter of subjective opinion and it is not unusual for two appraisers to differ on the final opinion of value for the same property.

Recognizing the importance of accurate valuations, a brief discussion of the typical valuation methodologies follows:

### **6.1.1 Valuation Methodologies**

A typical real estate appraisal will involve one or more of the following approaches: the Cost Approach, the Income Approach and the Direct Comparison Approach.

#### **6.1.1.1 Cost Approach**

When applying the Cost Approach an appraiser attempts to estimate the cost to construct a reproduction of or a replicate of the subject property. In doing so, deductions are made for accrued depreciation. The end result will be an estimate of the cost of rebuilding an identical structure. Before adopting this approach, the appraiser must be satisfied that rebuilding the current structure represents the best use of the site.<sup>65</sup>

A summary of the steps involved in applying the Cost Approach is as follows:<sup>66</sup>

1. Estimate the value the land separately, as though vacant and capable of being used in its highest and best use.

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<sup>65</sup> *Canadian Valuation Service*, August 1999 (Scarborough, Ontario: Canada: Carswell, 1999), 12-514; *The Appraisal of Real Estate*, Canadian Edition. Winnipeg, Manitoba, Canada: Appraisal Institute of Canada, (1992), 311

<sup>66</sup> *Canadian Valuation Service*, August 1999, 12-514; *The Appraisal of Real Estate*, 307-308

2. Estimate the cost of reproducing the primary building(s) at the date of appraisal.  
This would include hard costs and soft costs.
3. Estimate the accrued depreciation in the building(s).
4. The estimate of accrued depreciation is then subtracted from the cost of reproduction to arrive at the estimate depreciated reproduction cost.
5. The value of the land as though vacant is then added to the depreciated reproduction cost to arrive at an estimated value for the property.

#### **6.1.1.2 Income Approach**

Income producing real estate is typically purchased as an investment and the amount of net rent is, therefore, a critical element affecting property value. This being the case, it is not surprising that the greater the net rental stream, the higher the value of the property.<sup>67</sup>

When applying the Income Approach, an appraiser studies a property's capacity to generate earnings and converts these earnings into an indication of present value.<sup>68</sup> This approach is most often applied to commercial properties (i.e. commercial and industrial buildings) where the properties are being leased at rents exposed to market forces.<sup>69</sup>

This approach incorporates rental income and operating expense forecasts, which implicitly incorporate the depreciation of the building and should reflect market values.<sup>70</sup>

A discount /capitalization rate is then estimated. In doing, some appraisers will impute a

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<sup>67</sup> *The Appraisal of Real Estate*, 399

<sup>68</sup> *The Appraisal of Real Estate*, 413

<sup>69</sup> *Canadian Valuation Service*, August 1999, 12-514

<sup>70</sup> *Canadian Valuation Service*, August 1999, 12-514

discount/capitalization rate based on transactions involving similar buildings while others will use rules of thumb and personal judgment in selecting an appropriate discount/capitalization rate.<sup>71</sup>

Appraisers applying the Income Approach can either capitalize an “estimated” current year net operating income or develop a model that discounts several year’s forecasts of net operating income. Appraisers will normally forecast net adjusted operating income for five to ten years with a terminal value based on a capitalization of the final year’s income into perpetuity.<sup>72</sup>

The general process using the capitalization approach can be summarized as<sup>73</sup>:

1. Assuming 100% occupancy, estimate gross income. This requires a review and consideration of existing leases, permitted annual rental adjustments as provided in leases or by legislation, leases about to expire and subsequent leasing at market rates. After estimating gross income, a deduction is made from this amount for vacancy to arrive at adjusted gross operating income.
2. Annual operating expenses are estimated.
3. Deduct estimated annual operating expenses from adjusted gross income to determine net adjusted operating income.
4. Capitalize the net adjusted operating income.

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<sup>71</sup> *Canadian Valuation Service*, August 1999, 12-514

<sup>72</sup> *Canadian Valuation Service*, August 1999, 12-517

<sup>73</sup> *Canadian Valuation Service*, August 1999, 12-517 to 12-518

The general process using the discount of net adjusted operating income method is essentially the same; however, a year over year analysis of forecast adjusted net operating income is performed.<sup>74</sup>

### **6.1.1.3 Direct Comparison Approach**

The direct comparison approach involves analysing sales of similar properties to the one being appraised in an effort to estimate its market value.<sup>75</sup> In applying the direct comparison approach, an appraiser will generally undertake the following steps<sup>76</sup>:

1. Conduct market research in the area of the subject property to identify recent sale transactions, listings, and offers to purchase properties that are similar to the subject property in terms of size, age, location, date of sale, zoning, etc.
2. Refine this list to identify only those properties that are most comparable in terms of size, use, age, location, time of sale, etc.;
3. Verify information gathered by contacting the buyer and/or seller or the respective agents of the property. This also provides an opportunity to gather additional information about the transaction that is not otherwise readily available that may have impacted the sale price such as unusual conditions of sale; and
4. Compare each transaction to the subject property and develop an estimate for the subject property after making adjustments for differences in the properties and conditions that may have influenced the market price of the comparable

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<sup>74</sup> *Canadian Valuation Service*, August 1999 , 12-517 to 12-518

<sup>75</sup> *The Appraisal of Real Estate*, 357; *Canadian Valuation Service*, August 1999 , 12-518

<sup>76</sup> *Canadian Valuation Service*, August 1999, 12-519; *The Appraisal of Real Estate*, 361

transaction. For example, property A may have sold for \$100,000, but is in a superior location. Therefore, a negative adjustment of say 10% would adjust for the subject property's inferior location. The comparable sale price, therefore, for the purposes of estimating the market value of the subject would be \$90,000.

## **7 THE VALUE OF AN ESTATE FREEZE**

As mentioned at the outset, another major aspect of this paper involves the quantifying of the value of an estate freeze for selected fact situations with a focus on the unincorporated real estate owner. In doing so, an attempt has been made to identify scenarios which are representative of a broad range of real estate activities/holdings of an unincorporated real estate owner. At one end of the spectrum is the passive real estate owner of a single family tenanted detached home, while at the other end of the spectrum is the active owner and operator/manager of a large 50 unit apartment building with several employees. Also considered will be the owner of a smaller 10 unit apartment building. The diversity of fact situations will, among other things, allow for a discussion of certain related topics which may impact the ultimate value of an estate freeze, particularly from the perspective of the unincorporated real estate owner. These related topics include the tax consequences of corporate ownership, the treatment of taxable capital gains and property income, and the concepts of active business income, the small business deduction, the refund dividend tax on hand account, the gross-up and dividend tax credit mechanism and finally, the applicability of the capital gains exemption pertaining to gains arising from the disposition of shares of a qualified small business corporation. Before proceeding to the valuation model, these related topics will first be reviewed generally. Afterwards they will be discussed more specifically in relation to the selected fact situations.

## **7.1 Related Topics Potentially Impacting Deferral Value of an Estate Freeze**

### **7.1.1 Tax Consequences Arising From Corporate Ownership**

As a consequence of real property being transferred to a holding corporation under an estate freeze, all income and gain that would otherwise have been received directly by an individual taxpayer is now being received by the holding corporation. In this regard, it is noteworthy that an investment property typically produces two benefits:

1. capital gains, and
2. income from property.

In the context of real estate, income from property is the stream of rental or lease payments received. A capital gain, on the other hand, only arises on disposition of real estate when it is disposed of for more than cost.<sup>77</sup> The distinction is important because income from property is fully included in the income of the taxpayer, while capital gains are only 50% included.

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<sup>77</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 175

### 7.1.1.1 Capital Gains

In the case when capital gains are realized by the holding corporation, as opposed to an individual, the obvious question that arises is: "Does this create a greater total tax burden now that there are two taxpayers as opposed to one, i.e. the corporate taxpayer and the shareholder taxpayer?" The answer is, "It depends".

In the case of non-taxable capital gains, there is no disadvantage from a tax perspective to earn capital gains through a corporation as opposed to directly. In contrast, however, in the case of taxable capital gains and income from property in the form of rent received, there is currently a greater tax burden in British Columbia based on 2003 tax rates when one earns taxable capital gains and rent through a holding corporation. This becomes apparent when one reviews Table 1 below.

As the reader is aware, taxable capital gains represent 50% of the capital gain. The remaining, non-taxable 50% of the capital gain is received by the holding corporation free of tax. This non-taxable portion of the capital gain can then be transferred tax-free to shareholders in the form of a capital dividend.<sup>78</sup>

As for the taxable portion of the capital gain, the holding corporation (which throughout this paper is assumed to be a Canadian Controlled Private Corporation, a "CCPC") is taxed in British Columbia at the basic Federal corporate rate of 38%, less the Provincial abatement of 10%, plus the Federal surtax of 1.12% giving a total of 29.12%. In the case

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<sup>78</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 495; *Canadian Master Tax Guide*, 59<sup>th</sup> Edition. (Toronto, Ontario: Canada: CCH Canadian Limited, 2004), 525

of Investment Income, which includes taxable capital gains and income from property in the form of rent received, an additional 6.67% is applied. Together with the Provincial rate of 13.5%, this gives a total of 49.12% (38%-10%+1.12%+ 6.67%+13.5%). A portion of this tax paid, equivalent to 26 2/3 % is, however, refundable to the holding corporation when the taxable capital gains are distributed to the shareholders in the form of dividends. This refund, which is achieved through the Refundable Dividend Tax On Hand Account (the "RDTOH account")<sup>79</sup>, together with the gross-up and dividend tax credit mechanism, reduces the effective corporate tax rate to 22.62%<sup>80</sup>. The reader will note from Line 11 and Line 12 of Table 1 below, that this effective corporate tax rate of 22.62% when added to the effective personal tax rate of the shareholder as determined by using the gross-up and tax credit mechanism (24.44%) gives a total combined tax rate of 47.06% which is higher than the personal tax rate of 43.7% for an individual in the highest tax bracket. In other words, the amount of combined tax paid by the holding corporation and shareholder when considered as a single unit, is higher than the amount that would have been paid by an individual in the highest marginal tax bracket, earning that same amount of income directly. It seems, therefore, that there is a tax penalty equivalent to an additional 3.36% (47.06%-43.7%) associated with realizing capital gains through a holding corporation for the unincorporated real estate owner in the highest marginal tax bracket in British Columbia.

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<sup>79</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 495

<sup>80</sup> *Canadian Master Tax Guide*, 59<sup>th</sup> Edition. (Toronto, Ontario: Canada: CCH Canadian Limited, 2004), xxiv & 824; Robert E. Beam, Stanley N. Laiken, and James J. Barnett, *Introduction to Federal Income Taxation in Canada*. (24<sup>th</sup> ed. Toronto, Ontario: Canada: CCH Canadian Limited, 2003-2004), 708 to 710

**Table 1 Taxable Capital Gains (2003 Federal and BC Rates - CCPC)**

**Taxable Capital Gains (2003 Federal and BC Rates - CCPC)**

**Tax Bracket of Shareholder (Combined Federal and BC Rate) 43.70%**

1. Taxable Portion of Capital Gain	\$ 100.00
2. Corporate income tax (combined rate of 22.62%)*	<u>-\$ 22.62</u>
3. Corporate Income after tax	\$ 77.38
4. Dividend paid to shareholder	\$ 77.38
5. Gross-up of one quarter	<u>\$ 19.35</u>
6. Taxable Amount	\$ 96.73
7. Personal Income Tax	\$ 42.27
8. Dividend Tax Credit (18.43%)	<u>\$ 17.83</u>
9. Net Personal Income Tax	\$ 24.44
10. Tax paid by Corporation	<u>\$ 22.62</u>
11. Total tax paid by Corporation and shareholder	\$ 47.06
12. Tax if shareholder earned \$100 directly	\$ 43.70

**RESULT: more tax paid by earning capital gains through Corporation. Corporation pays 3.36% more tax (\$47.06 - \$43.70).**

**\* Note: Combined Corporate Income Tax Rate Determined as follows:**

- The federal rates = 38% (Basic Rate) less Provincial Abatement of 10%, plus federal surtax of 1.12% = 29.12%.
- For investment income(which includes taxable capital gains and income from property in the form of rent received) a further 6.67% is added.
- To this added the Provincial Rate of 13.5% which give a total of 49.29%.
- This tax rate of 49.29% can be reduced by 26.67% when the corporation pays out taxable dividends as it does in Table 1, Line 4 above.
- Through the RDTOH account rules, the corporation is refunded by CCRA \$1.00 for every \$3.00 of taxable dividends distributed to shareholders. In our example, where the taxable portion of capital gain equals \$100 (Line 1), after paying out \$80 in dividends, the corporation gets back \$26.67. Therefore, on \$100 of corporate income (Line 1), if the corporation pays out \$80 in dividends it will recover \$26.67.
- This is equivalent to a reduction in the tax rate equal to 26.67%, leaving an effective tax rate of 22.62%.
- When comparing Line 11 with Line 12 it becomes apparent that there is a tax disincentive to receive capital gains through a corporation.

### **7.1.1.2 Income from Property**

In addition to capital gains, real property also generates a stream of rental income in the form of rents or lease payments. This form of property income, when received by the holding corporation, is taxed in similar fashion to the taxable portion of the capital gains discussed above. Through the application of the RDTOH account and the gross-up and dividend tax credit mechanism, the effective corporate tax rate (based on 2003 tax rates in BC) on rent received is similarly reduced from 49.29% to 22.62%. When combined with the effective personal tax rate of 24.44% for the individual (as calculated when applying the gross-up and dividend tax credit mechanism) in the highest marginal tax bracket of 43.7%, gives a total tax rate of 47.06% (i.e. 22.62% + 24.44%). As in the case of taxable capital gains, the reduction in tax resulting from the combined effect of the RDTOH account and the gross-up and dividend tax credit mechanism, does not achieve full integration. In other words, the total amount of tax paid by the corporation and shareholder together, exceeds the amount of tax that would be paid by the individual had the rental income been earned directly. This is illustrated by Table 2.

It appears, therefore, that an individual is also worse off by receiving rental income as dividends via a holding corporation, as opposed to receiving rental income directly. The reader will note that the amount of the additional tax for an individual in the highest marginal tax bracket in BC is 3.36%. This is equivalent to the additional tax payable on taxable capital gains at that same marginal tax bracket. This similarity is expected as taxable capital gains and income from property in the form of rent are both considered investment income and accordingly are taxed identically.

**Table 2 Rental Income (2003 Federal and BC Rates - CCPC)**

**Rental Income (2003 Federal and BC Rates - CCPC)**

**Tax Bracket of Shareholder (Combined Federal and BC Rate) 43.70%**

1. Corporate income before tax	\$ 100.00
2. Corporate income tax (combined rate of 22.62%)*	<u>-\$ 22.62</u>
3. Corporate Income after tax	\$ 77.38
4. Dividend paid to shareholder	\$ 77.38
5. Gross-up of one quarter	<u>\$ 19.35</u>
6. Taxable Amount	\$ 96.73
7. Personal Income Tax	\$ 42.27
8. Dividend Tax Credit (18.43%)	<u>\$ 17.83</u>
9. Net Personal Income Tax	\$ 24.44
10. Tax paid by Corporation	<u>\$ 22.62</u>
11. Total tax paid by Corporation and shareholder	\$ 47.06
12. Tax if shareholder earned \$100 directly	\$ 43.70

**RESULT: more tax paid by earning rental income through Corporation.  
Corporation pays 3.36% more tax (\$47.06 - \$43.70).**

**\* Note: Combined Corporate Income Tax Rate Determined as follows:**

- The federal rates = 38% (Basic Rate) less Provincial Abatement of 10%, plus federal surtax of 1.12% = 29.12%.
- For investment income(which includes taxable capital gains and income from property in the form of rent received) a further 6.67% is added.
- To this added the Provincial Rate of 13.5% which give a total of 49.29%.
- This tax rate of 49.29% can be reduced by 26.67% when the corporation pays out taxable dividends as it does in Table 1, Line 4 above.
- Through the RDTOH account rules, the corporation is refunded by CCRA \$1.00 for every \$3.00 of taxable dividends distributed to shareholders. In our example, where the taxable portion of capital gain equals \$100 (Line 1), after paying out \$80 in dividends, the corporation gets back \$26.67. Therefore, on \$100 of corporate income (Line 1), if the corporation pays out \$80 in dividends it will recover \$26.67.
- This is equivalent to a reduction in the tax rate equal to 26.67%, leaving an effective tax rate of 22.62%.
- When comparing Line 11 with Line 12 it becomes apparent that there is a tax disincentive to receive rental income through a corporation.

## 7.1.2 Income from Property vs. Active Business Income and the Small Business Deduction

### 7.1.2.1 The Small Business Deduction

Section 125 of the Income Tax Act provides a “small business deduction” that allows a CCPC to deduct from its tax otherwise payable 16% of its active business income earned in Canada up to a specified limit.<sup>81</sup> The specified limit as of January 1, 2003 was \$225,000. The small business deduction effectively acts as a tax credit in that it is a deduction from tax, not income. The result is that it reduces the Federal tax rate to 13.12%, which when combined with the Provincial rate of 4.5%, brings the total effective tax rate on the first \$225,000 of qualifying active business income in British Columbia to 17.62%.<sup>82</sup> This translates into a potential “saving” of tax of approximately 26.08% per year which on \$225,000 of active business income translates into \$58,680 annually. Having said this, the small business deduction is not truly a savings of tax because there will be an additional tax cost when the retained earnings are distributed to the shareholders. However, until a distribution is made, a significant tax deferral is realized in the corporation.<sup>83</sup>

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<sup>81</sup> Robert E. Beam, Stanley N. Laiken, and James J. Barnett, *Introduction to Federal Income Taxation in Canada*. (24<sup>th</sup> ed. Toronto, Ontario: Canada: CCH Canadian Limited, 2003-2004), 752; Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 495

<sup>82</sup> *Canadian Master Tax Guide*, 59<sup>th</sup> Edition. (Toronto, Ontario: Canada: CCH Canadian Limited, 2004), xxiv & xxvi

<sup>83</sup> David R. Baxter, “Tax Issues for Solicitors” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Solicitors’ Tax Issues, Vancouver, BC, Canada, October 19, 2000), 1.1.02 to 1.1.03; William S. Maclagan and Michael Coburn, “Tax for the Non-Specialist - 2003 Update,” (materials prepared for the Continuing Legal Education Society of BC’s Continuing Legal Education seminar, Tax for the General Practitioner, Vancouver, BC, February 21, 2003), 5.1.01

A comparison of the tax payable on \$100 of active business income by a corporation and its shareholder versus an individual in the highest marginal tax bracket of 43.7% earning that same \$100 directly, is set out in Table 3.

**Table 3 Active Business Income Up to \$225,000 (2003 Federal and BC Rates - CCPC)**

<u>Active Business Income Up to \$225,000</u> <u>(2003 Federal and BC Rates - CCPC)</u>	
<b>Tax Bracket of Shareholder (Combined Federal and BC Rate) 43.70%</b>	
1. Corp. Active Business Income before tax	\$ 100.00
2. Corporate income tax (combined rate of 17.62%)*	<u>-\$ 17.62</u>
3. Corporate Income after tax	\$ 82.38
4. Tax if individual earned \$100 directly	\$ 43.70
5. Personal Income after tax	\$ 56.30
 <b>RESULT: 26.08% more tax paid by Individual on active business income (\$43.70 - \$17.62).</b>	
 <b>* Note: Combined Corporate Income Tax Rate Determined as follows:</b>	
<ul style="list-style-type: none"> <li>- The basic federal rate of 38%, less the Provincial abatement of 10%, plus federal surtax of 1.12% gives a total of 29.12%. From this amount is subtracted the federal small business deduction of 16%, leaving 13.12%. To this is added the 4.5% of Provincial tax on the first \$225,000 of active business income giving a total tax rate of 17.62% on the first \$225,000 of active business income.</li> </ul>	

As explained, the small business deduction is only available to CCPCs. That being the case, a holding corporation that generates active business income pays less tax than a sole proprietor (or unincorporated real estate owner) generating that same amount of active business income. To appreciate the significance of this result to real estate earnings, one

must determine what real estate earnings constitute active business income. To do this, one must first consider the definition an “active business” set out in subsection 125(7) of the Income Tax Act which provides that an:

*“active business carried on by a corporation” means any business carried on by the corporation other than a specified investment business or a personal services business and includes an adventure or concern in the nature of trade.”*<sup>84</sup>

From the above definition, it is apparent that a if a CCPC’s income is business income, then it qualifies for the small business deduction (subject to the prescribed limits), provided it does not come within one of the two exceptions. Those exceptions being a “specified investment business” or a “personal services business”.<sup>85</sup> Generally speaking, a specified investment business is a business whose principal purpose is to derive income from property, whereas a personal services business relates to incorporated employees.<sup>86</sup>

At first glance, the first exception, i.e. a specified investment business, would seem to capture a business that received income in the form of rents from property. This would then lead one to conclude that a corporation that owned real estate and generated rental income would not be able to take advantage of the small business deduction. A more careful review of the definition of specified investment business, however, discloses that this is not always the case. In particular, where the business employs more than five full-

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<sup>84</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*. (Fourth Edition. Toronto, Ontario: Canada: Carswell, 2002), 496

<sup>85</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*, 755

<sup>86</sup> Section 125(7) of the Income Tax Act; *Canadian Master Tax Guide*, 59<sup>th</sup> Edition. (Toronto, Ontario: Canada: CCH Canadian Limited, 2004), 756

time employees throughout the year, it will be considered to be an active business and thus eligible for the small business deduction.<sup>87</sup> According to Hogg, Magee and Li the existence of more than 5 full-time employees recognizes that once a company earning property income has reached a certain level of activity, it should be regarded as active.<sup>88</sup>

It can be concluded therefore, that a real estate corporation that generates income from property in the form of rent is eligible for the small business deduction provided it employs more than 5 full-time employees.

#### **7.1.2.2 Business Income vs. Income from Property**

Despite the above, the small business deduction may also be available to a real estate corporation that receives rent from real estate but does not have more than 5 full-time employees. This would occur in situations where the rental receipts are considered “business income” as opposed to “income from property”. In such circumstances, the corporation would not be engaged in a business whose principal purpose is to derive income from property. Recall, the definition of active business excluded specified investment businesses whose principal purpose was to derive income from property. Therefore, if the income generated from the real estate corporation is considered business income, as opposed to income from property, it will also be eligible for the small business deduction regardless of the number of employees it has.

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<sup>87</sup> Section 125(7) of the Income Tax Act; Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*, 496

<sup>88</sup> Peter W. Hogg, Joanne, E. Magee, and Jinyan Li, *Principles of Canadian Income Tax Law*, 496

To ascertain what distinguishes business income from property income, one must first look to their definitions in the Income Tax Act. Unfortunately, the definitions of “business” and “property” in subsection 248(1) of the Income Tax Act are very broad and as such are of little assistance. This being the case, one must then turn to the jurisprudence in order to establish the circumstances under which rent received will be construed as business income as opposed to income from property. Not surprisingly, this is determined on a case-by-case basis. Having said this, there are some general guidelines that emerge from Court decisions on the issue. A consideration of the leading cases that have been identified and summarized in the *Canadian Real Estate and Taxation Guide*<sup>89</sup> is helpful.

#### ***7.1.2.2.1 Rental Income Earned Through a Corporation***

In situations where the rental income is earned through a corporation, as opposed to personally, there is a rebuttable presumption that the rents constitute business income provided the corporation is formed for specific objects and carries out those objects.<sup>90</sup> What this means is that the Courts begin the analysis presuming that the income earned by the corporation is considered to be income from business. Consequently, the evidentiary burden to establish that it is not income from business rests with the Government, in this case the CCRA. What is not clear, however, is whether this

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<sup>89</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*. (Toronto, Ontario: Canada: CCH Canadian Limited, 1989).

<sup>90</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*, 16,155

presumption applies to corporations incorporated under modern corporate statutes that do not need to list specific corporate objects.<sup>91</sup>

In *Burri v. The Queen*, 85 DTC 5287 (F.C.T.D.) the presumption that a corporation earns income from a business was successfully rebutted by the Ministry of National Revenue.

The Court held that the rental income of the two corporate taxpayers came to them essentially as owners of property income and not as operators of a business. In the *Burri* case, the taxpayers were corporations that rented out two apartments. The apartments were rented unfurnished, except for stoves and refrigerators and coin-operated laundry facilities for communal use. The tenants were also provided with parking and one of the buildings provided cable television and the right to use the swimming pool shared with tenants of other buildings. The buildings were managed by a property management company controlled by the plaintiffs. The Court held that the rents constituted property income on the basis that the services provided to the tenants were limited in nature and typical of what any owner of a modern apartment building would expect to have to provide to tenants. The Court also added that the services were incidental to the earning of property income.

The decision of *Burri* cannot be reconciled with the earlier decision in *The Queen v. Cadboro Bay Holdings Ltd.*, 77 DTC 5115 (F.C.T.D.)<sup>92</sup>. In the *Burri* case, a corporation owned and operated a shopping centre with seven tenants and the principal officer of the corporation was actively involved in the operations. His duties included negotiating

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<sup>91</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*, 16,155

<sup>92</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*, 16,155

leases, arranging for maintenance services, handling complaints and managing the centre generally. The Court held that the rental income was business income primarily on the basis that the principal or sole activity of a corporation constituted a business. It has also been observed that numerous subsequent decisions have held corporate taxpayers who derived rental income while performing minimal services were found to have earned income from a business.<sup>93</sup> As such, the correctness of the decision in *Burri* should be questioned in light of these decisions, which suggest a continued presumption that a corporation earns business income.

A more recent decision, subsequent to the *Burri* decision, in support of this presumption is that of *Etoile Immobiliere S.A. v. The Minister of National Revenue*, 92 DTC 1984 (T.C.C.). In this case the corporate taxpayer owned a large residential complex in Montreal comprised of 158 townhouse units spread over 8 acres. The units were rented unfurnished. Indoor parking was provided. The stoves and refrigerators belonged either to the tenants or to the taxpayer and there was a mixed system for washers and dryers with some belonging to an outside third party and others belonging to the taxpayer. The complex was managed by an unrelated property management company that deployed several employees to the premises. According to its corporate documents, the corporate taxpayer's main object was to acquire and administer property. The Court held that since the corporate taxpayer's income was derived from activities consistent with its corporate objects, the income was properly characterized as business income.

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<sup>93</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*, 16,156

The continued presumption that rental income earned through a corporation (whose corporate objects provide for the collection of rents and administration of property) will be considered business income, is consistent with the position of the CCRA as set out in Interpretation Bulletin, IT-73R6.

### **7.1.3 Capital Gains Exemption**

Another advantage to having rental income characterized as business income, as opposed to property income, is that it potentially presents an opportunity for the unincorporated real estate owner's children to take advantage of the \$500,000 Capital Gains Exemption available on the transfer of qualified small business corporation shares. On this point, through the estate freeze process, an unincorporated real estate owner could transfer real estate to a newly created corporation ("Holdco") on a tax deferred basis pursuant to the subsection 85(1) rollover discussed in this paper. A gain arising on the subsequent disposition of the Holdco shares by the children could then be eligible for the \$500,000 capital gains exemption if substantially all of the Holdco shares are used in an active business carried on primarily in Canada by Holdco.<sup>94</sup> The author cautions, however, that the rules relating to the applicability of the capital gains exemption in respect of qualified small business corporation shares are complex and a detailed discussion of them is beyond the scope of this paper.

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<sup>94</sup> Peter, L. Clark, and Ian V MacInnis, *Canadian Real Estate Income Tax Guide*, 11,103

## **8 THE MODIFIED VALUATION MODEL –**

### **CALCULATING THE VALUE OF AN ESTATE FREEZE**

As discussed in Part 1, the primary benefit of an estate freeze is that it allows the future capital growth in the real property to be taxed in the hands of the children rather than in the hands of the Parents. Building upon a model developed by Chu, Feltham and Mathieu (the “Valuation Model”), the deferral value of these future capital gains can be quantified.<sup>95</sup> At this point, I should point out that although the Valuation Model was premised on the transfer of shares into a holding corporation, it is the author’s opinion that the model, with modifications, can also be applied to the transfer of real property to a holding corporation. Despite the fact that the Valuation Model, as modified, is being applied to a real estate context, the author acknowledges that the work and methodology employed in this paper in calculating the deferral value of an estate freeze builds upon the Valuation Model as developed by Chu, Feltham and Mathieu.

#### **8.1 The Objective – To Increase Family Wealth**

Consistent with the Valuation Model and for the purposes of this paper, the value of an estate freeze is defined as the value of deferring the payment of tax on future growth, i.e.

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<sup>95</sup> Ling Chu, Glenn Feltham, and Robert Mathieu, “The Deferral Value of Estate Freezes,” *The Canadian Tax Journal* (2001): Vol. 49, No. 2

the value of having children, rather than the parent, taxed on future growth.<sup>96</sup> Hence, the objective is to determine whether performing an estate freeze increases the after-tax future wealth of the family as a whole.

## 8.2 Disposition of Property

If the Parents do not perform an estate freeze, they will pay tax when they sell their interests in the real property. Alternatively, tax will be paid in the case of the death of the last surviving Parent because death is construed by the Income Tax Act as a deemed disposition. (It is assumed the Parents own the real property as Joint Tenants and as a consequence, the right of survivorship applies).

Many of the assumptions of the Valuation Model are extended to the modified model (the "Modified Valuation Model"). For example, the Modified Valuation Model assumes that the disposition date, if the Parents do not perform an estate freeze, and the redemption date if the Parents do perform an estate freeze, are the same date (note: redemption would occur on the death of the last surviving Parent). More generally and also consistent with the Valuation Model, is the assumption that appropriate tax planning steps will be taken to avoid any element of double taxation.<sup>97</sup>

The Modified Valuation Model also assumes that the after-tax amount left by the last surviving Parent on redemption if the Parents performed an estate freeze is reinvested in

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<sup>96</sup> Ling Chu, Glenn Feltham, and Robert Mathieu, "The Deferral Value of Estate Freezes," *The Canadian Tax Journal* (2001): Vol. 49, No. 2: 347

<sup>97</sup> Ling Chu, Glenn Feltham, and Robert Mathieu, "The Deferral Value of Estate Freezes," *The Canadian Tax Journal* (2001): Vol. 49, No. 2: 348 and 366 (footnote 4)

the holding corporation. For the purposes of this paper, such reinvestment will be in the nature of a capital reinvestment enjoying the same rate of growth,  $R$ , as the real property. This capital reinvestment will be referred throughout this paper as the "Reinvestment Property".

### **8.3 Disposition by the Children**

In applying the Valuation Model to the real estate context, two disposition options are possible. First, the disposition of the common shares of the holding corporation themselves and secondly, the disposition of the assets owned by the holding corporation, i.e. the real property and the Reinvestment Property. The latter option will likely be the more common of the two as a purchaser will be less willing to assume any potential hidden obligations and/or liabilities of the holding corporation. After all, when purchasing shares, as opposed to assets, one is purchasing the corporation "warts and all".

Where, an opportunity exists to take advantage of the \$500,000 capital gains exemption applicable to the disposition of qualified small business corporation shares, the children may, however, insist on the disposition of the shares of the holding corporation.

### **8.4 The Modified Valuation Model Inputs/Variables**

Applying the above assumptions, the Modified Valuation Model determines the value of an estate freeze using many of the same variables/inputs as the original Valuation Model.

Several variables such as  $R_1$ ,  $R_2$ ,  $T_d$ ,  $I$ ,  $g$  and  $i$  have been added. Others have been

modified slightly to account for the fact that the modified model focuses on real property:

$N_p$  = the number of years from now until the last surviving Parent would dispose of the real property in the absence of an estate freeze (in this case disposition will occur as a result of the death of the last surviving Parent)

$N_c$  = the number of years from now until the children sell the real property

$R$  = the expected rate of growth of the real property, i.e. the rate of growth of capital

$T_p$  = the last surviving Parent's marginal tax rate on capital gains

$T_c$  = the children's marginal tax rate on capital gains

$C$  = the combined adjusted cost base of the real property (adjusted cost base of land + adjusted cost base of building)

$v$  = the fair market value of the real property at the time of the freeze (today).

$R_1$  = Recapture on building = the adjusted cost base of the building situated on the real property, minus its undepreciated capital cost ("UCC") at the time of disposition

$R_2$  = Recapture on Reinvestment Property = the adjusted cost base of the building on the Reinvestment Property, minus its undepreciated capital cost ("UCC") at the time of disposition

$T_d$  = the percentage difference in overall tax paid on income or capital gain by the holding corporation and shareholder as a unit vs. an individual earning the same income or capital gain directly. For clarification, the reader will note that according to Table 1 for the year 2003 in BC, at the shareholder tax bracket of 43.7%, the total tax paid on taxable capital gains by a corporation and its shareholder as a single unit (see Line 11 of Table 1) was 3.36% higher than tax paid by the individual earning that same income directly. Under these circumstances  $T_d = 3.36\%$ . Similarly, in Table 2, which relates to rental income,  $T_d = 3.36\%$ .

$I_1$  = the net annual rent of the real property for the year  $N=1$  and received annually thereafter

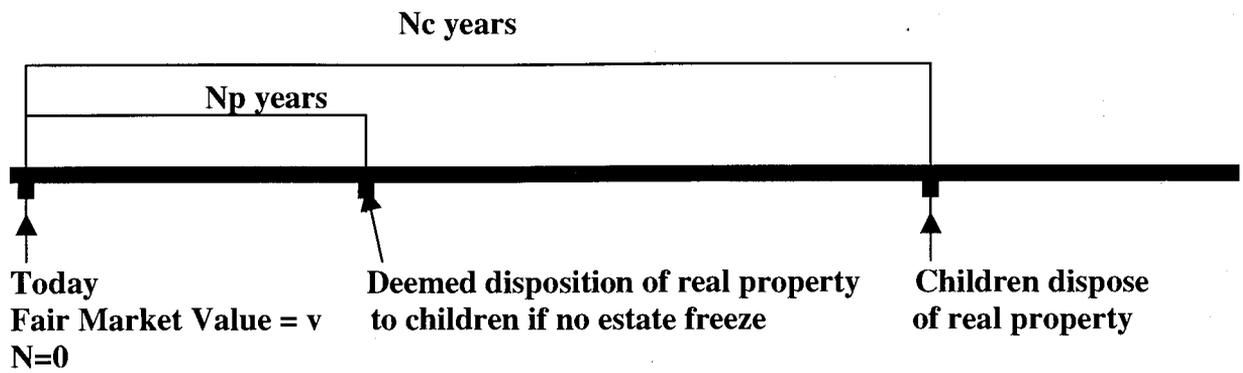
$I_2$  = the net annual rent of the Reinvested Property for the year  $N_{p+1}$  and received annually thereafter

$g$  = the annual growth rate of rents and expenses

$i$  = the interest rate on the accumulating, after-tax, net rental income and the interest rate on debt

Figure 2 below illustrates the timeline associated with the above variables.

Figure 2 Timeline



If an estate freeze is performed, then the children own the common shares (the growth shares) of the holding corporation for  $N_c$  years. If an estate freeze is not performed, then the last surviving Parent continues to own the real property for  $N_p$  years and the children own the real property for  $N_c - N_p$  years (since the children will inherit the real property  $N_p$  years from now).

#### 8.4.1 Determining the Value of an Estate Freeze

To determine the value of an estate freeze, one needs to first calculate the after-tax values (where tax is paid by both the corporation and its shareholders) at year  $N_c$  of both the real property and the Reinvestment Property when disposed of by the corporation if an estate

freeze is performed. To this is added the after-tax net rents (where tax is paid by both the corporation and shareholders) accumulated by the corporation since the year  $N=0$ , the date that the freeze was implemented. This total, after-tax value when an estate freeze is performed is represented by,  $V_f$ .

The next step is to calculate the after-tax value (where tax is paid by the children) at year  $N_c$  of the real property and the Reinvestment Property if a freeze is not performed. To this is added the net after-tax (where tax is paid by the children) accumulated rents collected by the children since the year  $N_p$ , the date the children inherit the real property. This total, after-tax, value when an estate freeze is not performed is represented by,  $V_{nf}$ .

The value of the estate freeze,  $V$ , is the difference between these amounts.<sup>98</sup>, i.e.  $V_f - V_{nf}$ .

In other words,  $V$ , represents how much additional wealth the family will have at year  $N_c$  if it performs an estate freeze.

## **8.4.2 More Details on some of the Variables**

### **8.4.2.1 $N_c$ & $N_p$ – Dates of Disposition**

Regarding the above variables to be inputted into the model, the values of  $N_p$  and  $N_c$  must be estimated. While the Parents would likely not care to predict how long the last surviving spouse will live, several estimates can be provided and the effect on the value of the estate freeze can be observed on that basis. Similarly, several estimates can be

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<sup>98</sup> Ling Chu, Glenn Feltham, and Robert Mathieu, "The Deferral Value of Estate Freezes," *The Canadian Tax Journal* (2001): Vol. 49, No. 2: 353

made for the length of time before the children dispose of the real property and the consequent effect on the value of the estate freeze can also be observed.

#### 8.4.2.2 R – the Expected Growth Rate of Real Property

The expected growth rate of the real property, R, can be estimated by looking at the past performance/ growth of the real property over the years. After determining its fair market value, the original purchase price and the length of time the real property has been held since acquisition, an annualized rate of return can be calculated. This figure can then be used as the value for R in the Valuation Model. For example, where

Fair Market Value of Land and Residence: \$200,000  
Rental Income: \$12,000.00 comprised of \$1000/month  
Annual Expenses: \$7000  
Net Annual Income: \$5000  
Purchase Price: \$50,000.00  
Date of Purchase: 1978

The rate of growth, R, can be estimated as follows:

$$\begin{aligned} \text{Holding Period Rate of Return} &= (\text{Fair Market Value} - \text{Purchase Price}) / \\ &\text{Purchase Price} \\ &= (\$200,000 - \$50,000) / \$50,000 \\ &= 3.0 \\ &= 300\% \end{aligned}$$

To obtain an estimate for R, the above Holding Period Rate of Return is annualized. Recall the holding period is 26 years (2004 – 1978).

$$\begin{aligned} R = \text{Annualized Rate of Return} &= (1+r)^{1/26} - 1 = (1+3.0)^{1/26} - 1 = \\ &0.054766 \\ &= 5.5\% \end{aligned}$$

It should be noted, however, that past performance/growth is not necessarily the best indicator of future growth. As many will acknowledge, real estate values can be very

volatile, at times experiencing significant fluctuations. Certain events can occur which can substantially increase the value of a property in a very short period. For example, the introduction of a local area plan by a municipality, which has the effect of redesignating the real property for a more valuable land use, could substantially increase its fair market value. This is particularly the case for properties which are on the fringe of urban development. While the market may attribute some value to the potential for redesignation, the full premium associated with redesignation will not be reflected in the market price of the real property until redesignation, in fact, occurs.

Regarding growth rates in a more general sense, it is interesting to note an observation made by Chu, Feltham and Mathieu.<sup>99</sup> Namely, according to a 1998 survey of Canadian organizations conducted by KPMG, the median long-term projection for real growth in gross domestic product is 2.5% while the projected inflation rate is 2.1%. Combining these numbers provides an estimation of the nominal projected rate of economic growth in Canada of 4.6%. Based on this and the assumption that small businesses will grow at a faster rate than the economy, Chu, Feltham and Mathieu felt long-term growth rates of 5 to 7 percent for small businesses seemed realistic.<sup>100</sup>

When assessing the growth performance of real estate relative to the economy, it may not be reasonable to expect growth performance to out-perform the economy, however, an assumption that real property will keep pace with the economy is acceptable.

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<sup>99</sup> Glenn Feltham, Tammi S. Feltham, and Robert Mathieu, "The Use of Estate Freezes by Family-Owned Businesses," *The Canadian Tax Journal* (2003): Vol 51, No. 4, 1532

<sup>100</sup> Glenn Feltham, Tammi S. Feltham, and Robert Mathieu, "The Use of Estate Freezes by Family-Owned Businesses," *The Canadian Tax Journal* (2003): Vol 51, No. 4, 1532

#### **8.4.2.3 Tp & Tc**

For the purposes of this paper, both Tc and Tp have been assumed to be equal to 21.85% which represents the marginal tax rate on capital gains for an individual in the highest tax bracket of 43.7%. To obtain the marginal rate on capital gains, one takes the income tax rate of 43.7% and divides it in half. This division in half reflects the fact that the inclusion rate on capital gains is 50%, i.e. 50% of capital gains are taxable as income.

It should be noted that where Tp is less than Tc, the deferral value of the estate freeze will be reduced. This being the case, the magnitude of the effect various rates for Tp should be observed before a decision to implement a freeze is made.

#### **8.4.2.4 C – the Adjusted Cost Base of the Real Property**

This variable represents the adjusted cost base of the real property. Normally, this is the purchase price, plus costs such as legal, accounting, etc. associated with its acquisition. For the purposes of our analysis of the selected fact situations, the adjusted cost base will be assumed to be the purchase price of the real property. The adjusted cost base of the real property is comprised of the adjusted cost base of the land plus the adjusted cost base of the building situated on the land.

#### **8.4.2.5 v- Fair Market Value**

The variable, v, which represents the fair market value of the real property at the time of the freeze, can be determined by an accredited appraiser using the valuation methodologies discussed in Section 6 of this paper. In the absence of a formal appraisal,

an owner may consider relying on assessed values of the real property provided they appear to be reasonable having regard to recent sales of similar properties in the area and provided the real property is located in a jurisdiction where actual value assessment is in place.

#### **8.4.2.6 $R_1$ & $R_2$**

Recapture,  $R_1$  &  $R_2$ , represents the difference between the adjusted cost base of the building on the real property (or the building on the Reinvestment Property), and its undepreciated capital cost ("UCC"). The amount of recapture is treated as income to the individual or corporation disposing of the real property or the Reinvestment Property and is taxed at the applicable income tax rates. For example, consider a building acquired for \$100,000 and depreciated to \$50,000. Its adjusted cost base is, therefore, \$100,000 and its UCC is \$50,000. If the building is sold for \$200,000, the difference between the adjusted cost base of the building and its UCC, i.e. \$50,000 must be recognized and taxed as income in the hands of the owner who disposed of the building.

Another important consideration regarding  $R_1$  &  $R_2$  is that the amount of recapture is date sensitive. The more an asset or building is depreciated, the lower its UCC and the higher the amount of recapture in the event the building or asset is sold for a profit.

## 9 THE VALUE OF A REAL PROPERTY ESTATE FREEZE

### 9.1 Methodology

As mentioned earlier, in order to determine the value of an estate freeze, one needs to first calculate the after-tax values (where tax is paid by both the corporation and its shareholders) at year  $N_c$  of both the real property and the Reinvestment Property when disposed of by the corporation if an estate freeze is performed. To this is added the after-tax net rents (where tax is paid by both the corporation and shareholders) accumulated by the corporation since the year  $N=0$ , the date that the freeze was implemented. This total, after-tax value when an estate freeze is performed is represented by,  $V_f$ .

The next step is to calculate the after-tax value (where tax is paid by the children) at year  $N_c$  of the real property and the Reinvestment Property if a freeze is not performed. To this is added the net after-tax (where tax is paid by the children) accumulated rents collected by the children since the year  $N_p$ , the date the children inherit the real property. This total, after-tax, value when an estate freeze is not performed is represented by,  $V_{nf}$ .

The value of the estate freeze,  $V$ , is the difference between these amounts.<sup>101</sup>, i.e.  $V_f - V_{nf}$ .

In other words,  $V$ , represents how much additional wealth the family will have at year  $N_c$  if it performs an estate freeze.

In both calculations of  $V_f$  and  $V_{nf}$ , account must be made for recapture triggered by the disposition of the real property and the Reinvestment Property.

## 9.2 The Value With An Estate Freeze

Applying the above methodology, it is necessary to determine the after-tax total family wealth attributable to the real property when the children, through the holding corporation, sell the real property and the Reinvestment Property. The Modified Valuation Model, accomplishes this by tracing the values of the real property, the Reinvestment Property and the accumulated, after-tax, net rental receipts, from the time of the freeze to the time of redemption (recall redemption will occur upon the death of the last surviving Parent which is assumed to be at  $N_p$  years) and finally, to the time when the children, through the holding corporation, sell the real property and the Reinvestment Property. The Modified Valuation Model includes, as a component of family wealth, the net rental, after-tax, receipts accumulated and distributed as dividends to the children from the time the estate freeze is implemented. These after-tax rental receipts reflect tax paid at both the corporate and shareholder level. In this way, the differences in total tax paid when comparing real property owned corporately, as opposed

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<sup>101</sup> Ling Chu, Glenn Feltham, and Robert Mathieu, "The Deferral Value of Estate Freezes," *The Canadian Tax Journal* (2001): Vol. 49, No. 2: 353

to personally, is properly accounted for. In this regard, the reader will recall from the discussions of Table 1 and Table 2, that the current tax system in BC is not fully integrated. That is, more total tax is paid by the corporation and its shareholder when viewed as a single unit as compared to the individual earning the same amount of income directly. Consequently, the Modified Valuation Model adjusts for the fact that collecting rent through a corporation is less profitable and, therefore, includes the net, after-tax, accumulated rental receipts as a component of family wealth when determining the value of an estate freeze.

Given that the marginal income tax rates of the Parents and children may not be the same, the model also accounts for recapture. In this way any differences that arise from the amount of recapture being taxed in the hands of different entities (i.e. the children, Parents or the corporation) are properly represented in the value of the estate freeze.

### **9.2.1 At the time of the Freeze**

At the time of the estate freeze, the fair market value,  $v$ , of the real property is determined and attributed to the preferred shares taken back by the Parents. Any growth in value of the real property from that time forward accrues to the benefit of the common shares held by the children. The avoidance of tax consequences at the time of the estate freeze is achieved by virtue of the application of a subsection 85(1) rollover which was reviewed earlier in this paper.

### 9.2.2 At Redemption

The preferred shares held by the Parents are redeemed  $Np$  years after the estate freeze, for the amount  $v$ . Note that because the preferred shares were frozen at their fair market value,  $v$ , (recall the shares were retractable by the Parents, and redeemable by the corporation, at the fair market value at the time of the freeze) their value at redemption remains  $v$ . The after-tax amount received by the estate of the last surviving Parent at redemption is, therefore,

$$v - (v - C)T_p$$

It should also be noted that at the time of redemption the corporation must come up with the funds in the amount of  $v$ , in order to redeem the Parent's preferred shares. This will constitute a debt to the corporation and, therefore, any interest payable must be accounted for in the Modified Valuation Model.

### 9.2.3 Reinvestment

Recall our objective is to determine whether an estate freeze increases after-tax family wealth. In doing so, the Modified Valuation Model assumes that the children, the beneficiaries of the last surviving Parent's estate, will reinvest the after-tax amount on redemption (i.e.  $[v - (v - C)T_p]$ ) in the holding corporation in an investment which will have the same expected growth rate of the real property, i.e. " $R$ ". For example, if redemption occurs at the death of the last surviving Parent, which is assumed to occur  $Np$

years from today, the children will be able to reinvest the after-tax amount leaving the total family wealth or value attributable to the real property, at the time of redemption at year  $Np$ , as

$$[v(1+R)^{Np} - v] + [v-(v-C)Tp] + (I)(1 - 2Tc+Td) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\}$$

Essentially, this equation represents the wealth that the family has immediately after redemption (after the death of the last surviving Parent and after taxes have been paid by the estate), if the after-tax amount is reinvested and if the after-tax net rent has been distributed to the children in the form of dividends. The net affect to the wealth of the family is a decrease in value equal to the taxes paid by the estate of the last surviving Parent.

The first term,  $[v(1+R)^{Np} - v]$ , reflects the value of equity of the real property after  $Np$  years, less the redemption amount paid to the last surviving Parent's estate. The second term,  $[v-(v-C)Tp]$ , is the amount reinvested in a capital asset and which we earlier labeled as the "Reinvestment Property". The second term also represents the adjusted cost base of the Reinvestment Property for the purposes of calculating capital gain upon its future disposition.

The final term,  $(1)(1 - 2T_c + T_d) \left\{ \frac{[(1+i)^{N_p} - (1+g)^{N_p}]}{(i-g)} \right\}$ , is the after-tax value (paid by the corporation and shareholders) of the accumulated net rental receipts calculated from the time the estate freeze was implemented and which have been distributed to the children (shareholders) as dividends. The formula used is that of the future value of a growing annuity, namely:  $FV = C \{ [(1+i)^N - (1+g)^N] / (i-g) \}$ .

The expression  $(2T_c + T_d)$  in the final term represents the effective rate of tax which would be paid on rental receipts when considering the holding corporation and its shareholders together. Under the RDTOH account rules and gross-up and dividend tax credit mechanism, this rate can only be achieved if dividends are actually paid to the children. Therefore, it is reasonable for the Modified Valuation Model to assume that such dividends are, in fact, paid to the children. Without paying dividends, the corporate tax rate would be significantly higher. The reader should also note that  $T_c$  is multiplied by 2 in order to convert the marginal tax rate on capital gains of the children to the marginal tax rate on income of the children. Adding  $2T_c$  and  $T_d$ , (i.e.  $2T_c + T_d$ ), then gives the effective tax rate on rental income when considering the holding corporation and its shareholders as one unit.

#### 9.2.4 Disposition by the Children

The equity in the real property and the Reinvestment Property, both defined above, will grow for  $N_c - N_p$  years, so that the before-tax values (i.e. before-tax is paid by the

corporation and the children as shareholders) of the real property and the Reinvestment Property, when the children dispose of them after  $N_c$  years, is

$$\{ [v(1+R)^{N_p} - v] + [v-(v-C)T_p] \} (1+R)^{N_c-N_p}$$

Or

$$[v(1+R)^{N_p} - v] (1+R)^{N_c-N_p} + [v-(v-C)T_p] (1+R)^{N_c-N_p}$$

The after-tax wealth of the family, after disposition by the children at year  $N_c$ , can be represented as the after-tax values of the real property and Reinvestment Property, combined with the after-tax value of the accumulated net rental receipts generated from the real property and the Reinvestment Property and paid out as dividends to the children. Account must also be made for recapture and for interest payable on the debt. Recall, the corporation is assumed to have borrowed to redeem the preferred shares of the Parents at the year  $N_p$ . To simplify the model, it is also assumed that there were no interest payments prior to the year  $N_c$ . The reader will also recall that recapture is triggered by the disposition of the real property and the Reinvestment Property:

### 9.2.5 Equation (1)

$V_f =$

$$[v(1+R)^{N_p} - v] (1+R)^{N_c-N_p} [1-(T_c+T_d/2)] +$$

$$\{ [v-(v-C)Tp] (1+R)^{Nc-Np} - [v-(v-C)Tp] \} [1-(Tc+Td/2)] +$$

$$(I_1+I_2)[1-(2Tc+Td)] \left\{ \frac{[(1+i)^{Nc} - (1+g)^{Nc}]}{(i-g)} \right\} - R_1 [ (2Tc + Td) ] - R_2 [ (2Tc + Td) ]$$

+

$$[v-(v-C)Tp] -$$

$$[v(1+i)^{Nc-Np} - v] +$$

$$[v(1+i)^{Nc-Np} - v] (2Tc+Td)$$

The first part of Equation (1),  $[v(1+R)^{Np} - v] (1+R)^{Nc-Np} [1-(Tc+Td/2)]$ , reflects the amount that remains after tax on the disposition of the equity of the real property at year  $Nc$ . The bracketed term,  $(Tc+Td/2)$  represents the effective marginal tax rate paid on capital gains when treating the corporation and its shareholders as a single unit. Recall, the variable  $Td$  represents the excess amount of tax paid by the corporation and its shareholders when considered as a unit when compared to an individual earning the same income directly. In order to convert this difference/excess in marginal income tax rates to the equivalent difference in marginal tax rates on capital gain, it is necessary to divide  $Td$  by 2. Thus,  $(Tc+Td/2)$  will represent the effective marginal tax rate on capital gains when treating the corporation and its shareholders as on unit, i.e. as a family.

The second part of the Equation 1,  $\{ [v-(v-C)Tp] (1+R)^{Nc-Np} - [v-(v-C)Tp] \} [1 - (Tc+Td/2)]$ , reflects the amount remaining after tax on the disposition of the Reinvestment Property at year  $Nc$ . It is determined by taking the Reinvestment Property's current value and subtracting its adjusted cost base of  $[v-(v-C)Tp]$ . This resulting figure is then multiplied by 1 minus the effective marginal tax rate on capital gains of the corporation and the shareholder together as one unit.

The third part of the Equation,  $(I_1 + I_2) [1 - (2Tc + Td)] \left\{ \frac{[(1+i)^{Nc} - (1+g)^{Nc}]}{(i-g)} \right\}$ , represents the accumulated, after-tax, net rental receipts collected from the real property and the Reinvested Property as at year  $Nc$ . As explained above, the bracketed term  $(2Tc+Td)$  represents the effective rate of tax on income which would be paid on rental receipts when considering the holding corporation and its shareholders as one unit. Under the RDTOH account rules and the gross-up and dividend tax credit mechanism, this rate can only be achieved if dividends are actually paid to the shareholders, i.e. the children. By multiplying  $Tc$  by 2, the marginal tax rate on capital gains of the children is converted to the marginal tax rate on income of the children. Therefore, adding  $2Tc$  and  $Td$ , (i.e.  $2Tc+Td$ ), then gives the effective tax rate on rental income when treating the holding corporation and its shareholders together as one unit.

The fourth and fifth parts of Equation (1),  $R_1 [ (2Tc + Td) ]$  and  $R_2 [ (2Tc + Td) ]$ , represent the tax payable as recapture which is triggered by the disposition of the real property and the Reinvestment Property at year  $N_c$ . Given that the disposition is by the holding corporation and that amount of recapture is treated as income to the holding corporation, it follows that to ascertain the impact of recapture on family wealth it is necessary to multiply the amount of recapture by the effective tax rate on income paid by the corporation and shareholders when treated as one unit. Once the amount of recapture is added to the income of the corporation, it is treated in the same way as investment income discussed earlier. Namely, the RDTOH account rules and the gross-up and dividend tax credit mechanism apply, which then reduces the effective rate of tax paid on the recapture amount. Treating the corporation and the shareholders together as one unit, results in an effective tax rate on income of  $(2Tc + Td)$ .

The next part of Equation 1,  $[v - (v - C)T_p]$ , represents the amount of equity in the Reinvestment Property that is not subject to tax.

What follows is,  $[v(1 + i)^{N_c - N_p} - v]$ , which represents the amount of interest payable by the corporation on the debt,  $v$ , which was incurred as a result of borrowing funds to redeem the Parents' preferred shares at year  $N_p$ . Recall it is assumed that prior to the year  $N_c$ , no payments have been made. As a result, interest payable has accrued for  $(N_c - N_p)$  years at a rate of debt equivalent to  $i$ .

The final part of Equation (1),  $\left[ v(1+i)^{Nc-Np} - v \right] (2Tc+Td)$ , reflects the tax savings to the corporation and shareholders together as a result of the fact that interest payments are deductible and thus reduce the amount of income subject to tax. Given that the model assessed tax payable without accounting for an interest deduction, the amount of tax that would have been avoided or saved is added back. Recall the rate of tax  $(2Tc+Td)$  represents the effective tax rate on income of the corporation and the shareholder when treated as a single unit.

### 9.3 The Value without a Freeze

#### 9.3.1 Disposition by the Parent

Pursuant to the provisions of the Income Tax Act, the last surviving Parent is deemed to have disposed of the real property on death (which according to our assumptions occurs  $Np$  years from now) at fair market value equal to:

$$v(1+R)^{Np}$$

Upon the deemed disposition and transfer of the real property to the children, however, the last surviving Parent's estate must pay tax on capital gains and must also account for recapture. The value of what remains after paying tax on capital gains and accounting for recapture is:

$$v(1+R)^{Np} - [v(1+R)^{Np} - C]Tp - R_1 2Tp$$

To this amount is added the accumulated after-tax (paid by the Parents) net rental receipts collected by the Parents since the date N=0. The rate of tax paid by the Parents on these rental receipts is 2Tp. By multiplying Tp by 2, the marginal tax rate of the Parents on capital gains is converted to the marginal tax rate on income of the Parents. Thus giving us the following :

$$v(1+R)^{Np} - [v(1+R)^{Np} - C]Tp - R_1 2Tp + (I_1)(1 - 2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\}$$

Rather than selling the property to pay the tax owing on capital gains and recapture, the Modified Valuation Model assumes that the children will borrow funds in the amount of the tax owing, i.e.  $\{ [v(1+R)^{Np} - C]Tp + R_1 2Tp \}$ .

### 9.3.2 Cash Lump-Sum Inherited by the Children

Consistent with the approach taken when we were calculating family wealth attributable to the real property when an estate freeze was implemented, it is similarly assumed that the cash received at year Np from the last surviving Parent's estate is included as a component of family wealth. The reader will recall that this lump-sum of cash, which is to be included as part of family wealth, is the accumulated, after-tax (where tax was paid by the Parents), net rents collected by the Parents since the year N=0 up to year Np. This amount is received tax free from the estate by the children and is represented as,

$$(I_1)(1 - 2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\}$$

This amount will accumulate interest at a rate, "i", until the year Nc.

### 9.3.3 Disposition by the Children

The amount defined above will grow for  $Nc - Np$  years, so that the before-tax value of the real property, at year Nc, when the children dispose of it, together with the lump-sum cash inheritance and the accumulated, after-tax (paid by the children), net rental receipts collected by the children from the real property since the year Np is,

$$\{ v(1+R)^{Np} - [ [v(1+R)^{Np} - C]Tp ] - R_1 2Tp \} (1+R)^{Nc-Np} +$$

$$(I_1)(1 - 2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\} (1+i)^{Nc-Np} +$$

$$[ \langle (I_1)(1+g)^{Np} + I_2 \rangle (1-2Tc) ] \left\{ \frac{[(1+i)^{Nc-Np} - (1+g)^{Nc-Np}]}{(i-g)} \right\}$$

The first part of the equation,  $\{ v(1+R)^{Np} - [ [v(1+R)^{Np} - C]Tp ] - R_1 2Tp \} (1+R)^{Nc-Np}$

, represents the value of the real property, less capital gains taxes payable upon the deemed disposition of the real property on the death of the last surviving Parent at the

year  $N_p$ , less recapture payable by the Parent's estate at the year  $N_p$ . This amount then grows for  $N_c - N_p$  years until the date of disposition by the children at year  $N_c$ . The growth factor is represented by  $(1+R)^{N_c - N_p}$ . It should also be noted that the tax on recapture is determined by multiplying the recapture amount,  $R_1$ , by  $2T_p$ . The marginal tax rate on capital gains of the Parent,  $T_p$ , is converted to the marginal tax rate on income of the Parent by multiplying by 2. Since the amount of recapture is added to the income of the Parent's estate, the marginal tax rate on income of the Parent is required. Hence,  $2T_p$ .

The second part of the equation above,  $(I_1)(1 - 2T_p) \left\{ \frac{[(1+i)^{N_p} - (1+g)^{N_p}]}{(i-g)} \right\} (1+i)^{N_c - N_p}$ ,

represents the lump sum of accumulated net, after-tax, rental receipts collected by the Parents and inherited by the children tax free upon the death of the last surviving Parent at year  $N_p$ . This amount accumulates interest at an interest rate, "i", from the date of inheritance,  $N_p$ , until the year  $N_c$ .

The next part of the equation,  $\left[ (I_1)(1+g)^{N_p} \right] (1-2T_c) \left\{ \frac{[(1+i)^{N_c - N_p} - (1+g)^{N_c - N_p}]}{(i-g)} \right\}$

, appears in the form of the future value of a growing annuity. Essentially, it represents the future value of the accumulated net, after-tax (paid by the children) rent receipts collected by the children from the real property beginning in the year  $N_p + 1$ . To determine what the first net rental receipt collected by the children from the real property in the year  $N_p + 1$ , it is necessary to take the original value of  $I_1$  and calculate its future

value in the year  $Np+1$ . This is accomplished by  $(I_1)(1+g)^{Np}$ . The accumulated net, after-tax, rental receipts generated by the real property for the number of years represented by  $Nc-Np$  is then calculated using the formula for the future value of a growing annuity.

Adjustments must also be made for interest payable on borrowed funds and for tax savings that result from the deductibility of interest. Based on our assumptions that the children borrowed to pay the tax owing by the Parent's estate at year  $Np$  and that no interest payments were made prior to the year  $Nc$ , the total interest payable by the children in the year  $Nc$  is represented by the following equation, where "i" equals the interest rate on debt:

$$\left\{ \left[ v(1+R)^{Np} - C \right] [I_p - R_1 2T_p] (1+i)^{Nc-Np} - \left[ v(1+R)^{Np} - C \right] [I_p - R_1 2T_p] \right\}$$

As for the tax savings associated with the deductibility of interest, this is represented by the amount of interest multiplied by the marginal rate of tax on income of the children. Recall, in order to obtain the marginal rate of tax on income of the children, one multiplies  $T_c$  by 2, (i.e.  $2T_c$ ). This gives us,

$$\left\{ \left[ v(1+R)^{Np} - C \right] [I_p - R_1 2T_p] (1+i)^{Nc-Np} - \left[ v(1+R)^{Np} - C \right] [I_p - R_1 2T_p] \right\} (2T_c)$$

Therefore, according to Modified Valuation Model the after-tax wealth of the family at year  $N_c$ , without an estate freeze, can be represented as the value, after-tax (paid by the children) of the real property,  $N_c$  years from now, together with the lump sum cash inheritance (i.e. the accumulated after-tax rent collected by Parents from  $N=0$  to the year  $N_p$ ) received from the last surviving Parent at year  $N_p$ . To this is added the amount of interest available, after-tax paid by the children, which has accumulated since the year  $N_p$  to the year  $N_c$  on the lump sum inheritance of accumulated net rental receipts. Also added is the after-tax (paid by the children) accumulated net rental receipts collected by the children from the real property. From this is subtracted recapture, which is triggered upon the disposition of the real property by the children at year  $N_c$ . A term is then added which adjusts for tax assessed against the portion of equity in the real property which is not subject to capital gains tax. Finally, the amount of interest payable is deducted and the tax savings arising from the deductibility of interest is added back:

### 9.3.4 Equation (2)

$V_{nf} =$

$$\{ v(1+R)^{N_p} - [v(1+R)^{N_p} - C]T_p - R_1 - 2T_p \} (1+R)^{N_c - N_p} (1 - T_c) +$$

$$(I_1)(1 - 2T_p) \left\{ \frac{[(1+i)^{N_p} - (1+g)^{N_p}]}{(i-g)} \right\} +$$

$$\left\langle \left\{ (I_1)(1 - 2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\} (1+i)^{Nc-Np} \right\} - (I_1)(1 - 2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\} \right\rangle (1-2Tc) +$$

$$\left[ \left\langle (I_1)(1+g)^{Np} \right\rangle (1-2Tc) \right] \left\{ \frac{[(1+i)^{Nc-Np} - (1+g)^{Nc-Np}]}{(i-g)} \right\} -$$

$$R_1 2Tc +$$

$$Tc \{ v(1+R)^{Np} - [v(1+R)^{Np} - C]Tp - R_1 2Tp \} -$$

$$\left\{ [v(1+R)^{Np} - C]Tp - R_1 2Tp \right\} (1+i)^{Nc-Np} - \left\{ [v(1+R)^{Np} - C]Tp - R_1 2Tp \right\} +$$

$$\left\{ [v(1+R)^{Np} - C]Tp - R_1 2Tp \right\} (1+i)^{Nc-Np} - \left\{ [v(1+R)^{Np} - C]Tp - R_1 2Tp \right\} (2Tc)$$

Regarding Equation (2),  $(I_1)(1 - 2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\}$  represents the cash

inheritance received tax-free from the last surviving Parent at year  $Np$ . This cash was is the accumulated net, after-tax (paid by the Parents) rent collected by the Parents from the real property from the year  $N=0$  to the year  $Np$ .

Associated with the lump sum cash inheritance received from the children is the next

term,  $\left\{ (I_1)(1 - 2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\} (1+i)^{Nc-Np} \right\} - (I_1)(1 -$

$2Tp) \left\{ \frac{[(1+i)^{Np} - (1+g)^{Np}]}{(i-g)} \right\} \right\}$ , which represents the amount of interest from the year

$Np$  to the year  $Nc$  which has accrued from the lump-sum cash inheritance received by the children. When multiplied by  $(1-2Tc)$  we are left with the amount remaining after the children pay tax on this interest income. Recall the marginal rate of income tax of the children is  $2Tc$ .

Another aspect of Equation (2) also require explanation. The term,  $Tc \{ v(1+R)^{Np} - [v(1+R)^{Np} - C]Tp - R_1 2Tp \}$ , represents the original equity in the real property at year  $Np$  (after the the estate of the last surviving Parent paid tax.and recapture) taxed at the rate  $Tc$ . This amount is added back to Equation (2) to adjust for the fact that all the childrens' equity in the real property was taxed in the first part of Equation (2). That part being,  $\{ v(1+R)^{Np} - [v(1+R)^{Np} - C]Tp - R_1 2Tp \} (1+R)^{Nc-Np} (1-Tc)$ .

The next part of Equation(2),

$\left\{ [v(1+R)^{Np} - C]Tp - R_1 2Tp \right\} (1+i)^{Nc-Np} - \left\{ [v(1+R)^{Np} - C]Tp - R_1 2Tp \right\}$ , represents the amount of interest owing on the funds borrowed to pay taxes that were payable at the year  $Np$ .

Finally,  $\left\{ \left[ v(1+R)^{Np} - C \right] T_p - R_1 2T_p \right\} (1+i)^{Nc-Np} - \left\{ \left[ v(1+R)^{Np} - C \right] T_p - R_1 2T_p \right\} (2Tc)$ ,

represents the tax savings arising from the deductibility of interest.

#### 9.4 The Value of the Freeze

According to the Valuation Model, the difference between the after-tax value, with an estate freeze,  $V_f$ , and the after-tax value without an estate freeze,  $V_{nf}$ , is the net increase in value, or the increase in family wealth, associated with the estate freeze  $Nc$  years from today. Thus,

$$V = V_f - V_{nf}, \text{ where } V \text{ denotes the future value of the estate freeze. } \quad (3)$$

## **10 OTHER COSTS ASSOCIATED WITH AN ESTATE**

### **FREEZE**

Aside from the deferral value of the estate freeze as calculated using the Modified Valuation Model, there are other costs that the Parents will incur upon implementing a freeze. Typically an individual interested in performing an estate freeze will consult a tax professional who will, among other things, prepare the necessary articles of incorporation, corporate resolutions, the section 85 agreement and section 85 filing. An appraisal from an accredited real estate appraiser may also be commissioned. Depending upon the jurisdiction, there will likely be additional costs triggered by the transfer of real property into the holding corporation as well. These costs may include property transfer tax and land title office registration fees. Finally, there are the annual accounting costs for having financial statements prepared and books maintained for the corporation.

Given that property transfer tax, if applicable, and associated land title office fees would presumably apply upon the disposition of the real property, whether a freeze is performed or not, they have been ignored for the purposes of this paper. On this point, any differences in property tax payable arising from differing dates of disposition, i.e. due to the time value of money, are assumed to be negligible.

As for the professional fees, limited empirical data is available. Having said this, a recent, though limited, survey of tax professionals was conducted by Chu, Feltham and

Mathieu. Based on their findings and the model they developed, the mean present value of professional costs (averaged across 10 respondents to the survey), with a discount rate of 7 percent, was estimated to be \$31,814.<sup>102</sup> In the absence of better information and given that the estate freeze contemplated in this paper is relatively simple, this estimate will be used for the purposes of the calculations in this paper.

In order to determine if there is a net benefit to proceeding with the estate freeze, the estimate of professional fees must be subtracted from the value of the estate freeze as calculated using the Modified Valuation Model. To do this an adjustment must be made to account for the time value of money. This adjustment can be achieved by calculating the present value of the value of the estate freeze using a discount rate. This can be accomplished by using the following formula where “d” represents the discount rate, V represents the value of the estate freeze and the figure \$31,814 represents the estimate of the professional fees to implement an estate freeze:

$$V_t = \left\{ \frac{V}{(1+d)^{N_c}} \right\} - \$31,814$$

Once this adjustment for time is made, the estimated present value of professional fees are then subtracted from the present value of the value of the estate freeze to determine if there is financial incentive, based on the assumptions set out, to proceed with an estate freeze. Financial incentive will, of course, exist if, after deducting the figure for professional fees, the deferral value remains greater than zero; i.e. there is a net benefit.

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<sup>102</sup> Glenn Feltham, Tammi S. Feltham, and Robert Mathieu, “The Use of Estate Freezes by Family-Owned Businesses,” *The Canadian Tax Journal* (2003): Vol 51, No. 4, 1533

## **11 APPLYING THE MODIFIED VALUATION MODEL**

### **11.1 Selected Fact Situations**

Mr. and Mrs. Taxpayer are 75 and 65 years old respectively. They have 3 adult children each of whom is professionally employed and earns income within the highest tax bracket. Mr. and Mrs. Taxpayer are considering an estate freeze for their single holding of real property that they have held over the years as an investment. They have provided two estimates for  $N_p$ , specifically, 10 years and 15 years. After discussing the matter with their children they have also provided 5, 10 and 20 years as the estimates for the length of time the children are prepared to hold onto the real property before disposing of it.

The marginal tax rate on capital gains for the children,  $T_c$ , is assumed to be 21.85%. This figure is equivalent to a 43.7% tax rate on income which represents the highest marginal tax rate on income for an individual in British Columbia in the year 2003.

The author has also assumed that the adjusted cost base of the real property in all selected fact situations below is equal to its purchase price.

#### **11.1.1 Scenario 1 - Tenanted Single Family House ("Single Family House")**

Size: 10 acres  
Zoning: Agricultural

Fair Market Value of Land and Building: \$200,000  
Rental Income: \$12,000.00 comprised of \$1000/month  
Annual Expenses: \$7000  
Net Annual Income: \$5000  
Purchase Price: \$50,000.00  
Date of Purchase: 1978

The rate of growth, R, can be estimated as follows:

$$\begin{aligned} \text{Holding Period Rate of Return} &= (\text{Fair Market Value} - \text{Purchase Price}) / \text{Purchase Price} \\ &= (\$200,000 - \$50,000) / \$50,000 \\ &= 3.0 \\ &= 300\% \end{aligned}$$

To obtain an estimate for R, the above Holding Period Rate of Return is annualized. Recall the holding period is 26 years (2004 – 1978).

$$\begin{aligned} R = \text{Annualized Rate of Return} &= (1+r)^{1/26} - 1 = (1+3.0)^{1/26} - 1 = 0.054766 \\ &= 5.5\% \end{aligned}$$

Alternatively, the rate of growth of capital, R, can be estimated to be the rate of growth of the economy which is approximately 4.6%.<sup>103</sup> For the purposes of our calculations the rate of growth of the economy will be used.

Aside from the net annual rental income generated from the real property,  $I_1 = \$5,000$ , it is also necessary to determine an estimate of the net annual rental income generated from the Reinvestment Property. This can be by determining the proportion of the fair market value the real property represented by rent and applying that same proportion to the Reinvestment Property. This is more easily understood if one reviews the calculations that follow:

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<sup>103</sup> Glenn Feltham, Tammi S. Feltham, and Robert Mathieu, "The Use of Estate Freezes by Family-Owned Businesses," *The Canadian Tax Journal* (2003): Vol 51, No. 4, 1532

$I_1/v = \$5,000/\$200,000 = 0.025$ , therefore

$I_2 / [v-(v-C)T_p] = 0.025$  where  $[v-(v-C)T_p]$  represents the fair market value of the Reinvestment Property at year  $N=0$ , i.e. the date the estate freeze is implemented.

Solving for  $I_2$  gives us,

$$\begin{aligned} I_2 &= 0.025 [v-(v-C)T_p] \\ &= 0.025 [\$200,000-(\$200,000-\$50,000)(0.2185)] \\ &= \$4180.62 \end{aligned}$$

Based on the above and assuming there is no recapture applicable to this situation, the inputs for the Valuation Model are:

$N_p = 10$  or  $15$   
 $N_c = 5$  or  $10$  or  $15$  or  $20$   
 $R = 4.6\%$  (estimated rate of growth of the economy)  
 $T_p = 21.85\%$   
 $T_c = 21.85\%$   
 $C = \$50,000$   
 $v = \$200,000$   
 $I_1 = \$5,000$   
 $I_2 = \$4180.62$   
 $i = 5.0\%$

#### *The Calculation Results for Scenario 1*

The results generated with the above inputs are set out in Table 4:

**Table 4 Single Family Dwelling and the Modified Valuation Model**

<b>Single Family House</b>												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
10	15	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$38,207.96	-\$13,435.32	
10	15	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$40,697.75	-\$12,237.69	
10	15	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$43,966.60	-\$10,665.31	
10	15	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$48,143.66	-\$8,656.08	
10	15	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$53,375.25	-\$6,139.59	
10	15	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$59,826.86	-\$3,036.26	
10	15	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$67,685.28	\$743.78	
<b>Single Family House</b>												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
10	20	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$54,244.34	-\$11,369.88	
10	20	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$60,704.01	-\$8,935.30	
10	20	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$69,290.67	-\$5,699.07	
10	20	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$80,474.48	-\$1,484.02	
10	20	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$94,813.12	\$3,920.07	
10	20	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$112,966.40	\$10,761.85	
10	20	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$135,713.04	\$19,334.82	
<b>Single Family House</b>												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
10	25	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$77,492.13	-\$8,930.36	
10	25	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$89,206.75	-\$5,471.00	
10	25	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$105,184.41	-\$752.75	
10	25	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$126,629.61	\$5,580.08	
10	25	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$155,045.17	\$13,971.27	
10	25	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$192,299.55	\$24,972.59	
10	25	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$240,708.33	\$39,267.84	

**Table 4 Single Family Dwelling and the Modified Valuation Model Continued**

<b>Single Family House</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
10	30	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$110,375.81	-\$6,275.53
10	30	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$129,026.29	-\$1,960.23
10	30	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$155,245.21	\$4,106.24
10	30	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$191,675.41	\$12,535.37
10	30	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$241,790.85	\$24,130.95
10	30	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$310,137.51	\$39,944.83
10	30	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$402,639.48	\$61,347.70
<b>Single Family House</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
15	20	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$78,820.06	-\$2,107.55
15	20	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$83,443.51	-\$365.02
15	20	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$89,727.16	\$2,003.22
15	20	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$98,051.49	\$5,140.58
15	20	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$108,871.22	\$9,218.42
15	20	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$122,728.19	\$14,440.96
15	20	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$140,266.34	\$21,050.91
<b>Single Family House</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
15	25	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$117,545.56	\$2,897.59
15	25	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$129,544.23	\$6,440.77
15	25	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$146,051.75	\$11,315.49
15	25	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$168,322.93	\$17,892.23
15	25	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$197,918.35	\$26,631.84
15	25	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$236,772.58	\$38,105.60
15	25	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$287,276.64	\$53,019.59

Table 4 Single Family Dwelling and the Modified Valuation Model Continued

Single Family House											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
15	30	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$170,068.74	\$7,536.07
15	30	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$191,823.75	\$12,569.69
15	30	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$222,506.70	\$19,669.03
15	30	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$265,112.22	\$29,526.99
15	30	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$323,539.52	\$43,045.75
15	30	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$402,846.66	\$61,395.63
15	30	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$509,572.06	\$86,089.48

Single Family House											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
15	35	4%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$240,675.46	\$11,818.12
15	35	5%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$275,300.19	\$18,095.25
15	35	6%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$325,583.03	\$27,211.04
15	35	7%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$397,767.77	\$40,297.43
15	35	8%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$500,391.04	\$58,902.03
15	35	9%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$645,072.82	\$85,131.44
15	35	10%	\$50,000.00	\$200,000.00	3.36%	\$5,000.00	\$4,180.62	3%	5.0%	\$847,565.04	\$121,841.31

As is apparent from final column,  $V_t$ , of Table 4, the value of the estate freeze when expressed in today's dollars (using a discount rate of 5%), after accounting for professional costs associated with implementing the freeze (discussed in Section 10), is at a maximum when the gap between  $N_p$  and  $N_c$  is at its greatest and when  $R$  is at its highest. This is not surprising and makes intuitive sense, since the length of time of the deferral in taxes is greatest the longer the children wait before disposing of the real property after an estate freeze has been implemented.

Another interesting observation is that an estate freeze is not always cost effective for this fact situation. This is the case when  $N_p=10$  and  $N_c=15$  for low values of  $R$ . The reader will note that the value of the estate freeze,  $V_t$ , under these circumstances is negative for

rates of R of 4% and 5%. The negative values calculated are -\$2,253.25 and -\$1055.61, respectively.

A final observation, is that even where the gap between  $N_p$  and  $N_c$  is at its greatest, the value of an estate freeze expressed in current dollars,  $V_t$ , is not extraordinarily high for rates of growth R which approximate the rate of growth of the economy (estimated to be 4.6%). For example, when  $N_p$  is 10 and  $N_c=30$ , the value of the estate freeze for rates of growth  $R=4\%$  and  $R=5\%$  are \$14,338.52 and \$18,653.81, respectively. Similarly when  $N_p=15$  and  $N_c=35$  and rates of growth are again 4% and 5%, the value of the estate freeze is only \$35,697.83 and \$41,974.96.

Based on the above, it appears that for realistic growth values, R, there is little, if any, incentive for the Mr. & Mrs. Taxpayer to proceed with the implementation of an estate freeze.

### **11.1.2 Scenario 2 - 10 Unit Residential Apartment Building (“Small Apartment Building”)**

Managed by Mr. & Mrs. Taxpayer

Fair Market Value of Land and Building: \$500,000

Rental Income: \$72,000 per annum, comprised of \$600/month per unit

Annual Expenses: \$25,000

Net Annual Income: \$47,000

Purchase Price: \$175,000

Date of Purchase: 1985

Using the same formula introduced in Scenario 1, the amount of rent generated by the Reinvestment Property can be calculated as follows:

$$I_1/v = \$47,000/\$500,000 = 0.094, \text{ therefore}$$

$I_2 / [v-(v-C)Tp] = 0.094$  where  $[v-(v-C)Tp]$  represents the fair market value of the Reinvestment Property at year  $N=0$ , i.e. the date the estate freeze is implemented.

Solving for  $I_2$  gives us,

$$\begin{aligned} I_2 &= 0.094 [v-(v-C)Tp] \\ &= 0.094 [\$500,000-(\$500,000-\$175,000)(0.2185)] \\ &= \$40,324.83 \end{aligned}$$

Based on the above and assuming no recapture, the inputs for the Modified Valuation

Model are:

$$\begin{aligned} Np &= 10 \text{ or } 15 \\ Nc &= 5 \text{ or } 10 \text{ or } 15 \text{ or } 20 \\ R &= 4.6\% \\ Tp &= 21.85\% \\ Tc &= 21.85\% \\ C &= \$175,000 \\ v &= \$525,000 \\ I_1 &= \$47,000 \\ I_2 &= \$40,324.83 \\ i &= 5.0\% \end{aligned}$$

### *The Calculation Results for Scenario 2*

The results generated with the above inputs are set out in Table 5:

**Table 5 10 Unit Apartment Building and the Modified Valuation Model**

<b>10 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
10	15	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$508,948.47	\$212,998.92
10	15	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$515,162.01	\$215,987.74
10	15	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$523,322.78	\$219,913.20
10	15	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$533,753.61	\$224,930.61
10	15	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$546,820.33	\$231,215.93
10	15	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$562,936.63	\$238,968.14
10	15	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$582,569.49	\$248,411.89
<b>10 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
10	20	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$828,522.80	\$280,447.53
10	20	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$844,644.70	\$286,523.70
10	20	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$866,081.63	\$294,603.06
10	20	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$894,008.78	\$305,128.51
10	20	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$929,820.18	\$318,625.45
10	20	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$975,165.13	\$335,715.48
10	20	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,031,990.17	\$357,132.24
<b>10 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
10	25	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,264,620.83	\$341,632.04
10	25	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,293,856.36	\$350,265.37
10	25	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,333,742.22	\$362,043.78
10	25	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,387,288.70	\$377,856.20
10	25	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,458,251.77	\$398,811.79
10	25	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,551,301.40	\$426,289.60
10	25	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,672,225.20	\$461,998.74

Table 5 10 Unit Apartment Building Continued

<b>10 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
10	30	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,853,905.58	\$397,137.94
10	30	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,900,446.93	\$407,906.56
10	30	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,965,892.59	\$423,049.21
10	30	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,056,846.49	\$444,093.89
10	30	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,181,989.85	\$473,049.25
10	30	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,352,683.35	\$512,543.87
10	30	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,583,732.14	\$566,003.35
<b>10 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
15	20	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$877,202.37	\$298,794.35
15	20	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$888,750.06	\$303,146.55
15	20	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$904,447.80	\$309,062.86
15	20	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$925,246.83	\$316,901.80
15	20	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$952,283.90	\$327,091.79
15	20	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$986,913.59	\$340,143.35
15	20	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,030,745.77	\$356,663.24
<b>10 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>
15	25	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,376,136.60	\$374,562.95
15	25	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,406,106.01	\$383,413.00
15	25	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,447,345.08	\$395,591.01
15	25	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,502,990.67	\$412,023.31
15	25	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,576,944.02	\$433,861.94
15	25	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,674,041.35	\$462,535.05
15	25	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$1,800,259.93	\$499,807.75

**Table 5 10 Unit Apartment Building Continued**

<b>10 Unit Apartment Building</b>												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
15	30	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,045,331.36	\$441,429.55	
15	30	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,099,667.87	\$454,001.80	
15	30	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,176,316.95	\$471,736.66	
15	30	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,282,764.21	\$496,366.16	
15	30	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,428,756.64	\$530,145.52	
15	30	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,626,938.18	\$576,000.25	
15	30	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,893,653.53	\$637,712.17	
<b>10 Unit Apartment Building</b>												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
15	35	4%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$2,936,940.12	\$500,624.71	
15	35	5%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$3,023,417.13	\$516,302.15	
15	35	6%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$3,149,022.58	\$539,073.20	
15	35	7%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$3,329,362.81	\$571,767.13	
15	35	8%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$3,585,775.77	\$618,252.31	
15	35	9%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$3,947,307.06	\$683,794.42	
15	35	10%	\$175,000.00	\$500,000.00	3.36%	\$47,000.00	\$40,324.83	3%	5.0%	\$4,453,331.47	\$775,531.73	

Table 5 demonstrates the enormous potential for an estate freeze to increase family wealth. This is true for all combinations of Np and Nc and for all rates of growth, R, considered. The range in estate freeze value, Vt, (using a discount rate of 5%) is from a low of \$212,998.92 to a high of \$775,531.73.

By implementing an estate freeze, Mr. & Mrs. Taxpayer may, with some aggressive tax planning, also be able to avail themselves of the small business deduction which amounts to an annual tax “savings” of approximately \$58,000 on the first \$225,000.00 of active business income. The reader will recall that in order to take advantage of the small

business deduction under these circumstances, the rental income generated from the apartment building must be characterized as business income, as opposed to income from property, in the hands of Mr & Mrs. Taxpayer. Provided receiving rent and management of buildings is expressly consistent with the objects of corporation as set out in its incorporation documents, there is a rebuttable presumption that the income earned by a corporation is business income. Having said this, each case that it litigated is dealt with on a case-by-case basis.

A further potential advantage of an estate freeze, is that the children may be able to take advantage of the \$500,000 capital gains exemption which applies to the disposition of shares of a qualified small business corporation. The author again cautions that the rules related to the applicability of the capital gains exemption in respect of qualified small business corporation shares are complex and beyond the scope of this paper. Where the exemption applies, the children must, of course, dispose of the shares of the holding corporation as opposed to the real property and the Reinvestment Property.

Under this scenario, it is clear that Mr. & Mrs. Taxpayer would increase family wealth substantially by implementing an estate freeze. Moreover, the family also stands to potentially benefit from the small business deduction and the applicability of the \$500,000 capital gains exemption should it apply.

### 11.1.3 Scenario 3 – 50 Unit Residential Apartment Building

Six full-time employees involved in operation/management of building  
Fair Market Value of Land and Building: \$2,750,000  
Rental Income: \$625,000 per annum, comprised of \$1050/month per unit  
Annual Expenses: \$400,000  
Net Annual Income: \$225,000  
Purchase Price: \$2,150,000  
Date of Purchase: 1999

The amount of rent generated by the Reinvestment Property can be calculated as follows:

$$I_1/v = \$225,000/\$2,750,000 = 0.0818, \text{ therefore}$$

$I_2 / [v-(v-C)Tp] = 0.0818$  where  $[v-(v-C)Tp]$  represents the fair market value of the Reinvestment Property at year  $N=0$ , i.e. the date the estate freeze is implemented. Solving for  $I_2$  gives us,

$$\begin{aligned} I_2 &= 0.0818 [v-(v-C)Tp] \\ &= 0.0818 [\$2,750,000 - (\$2,750,000 - \$2,150,000)(0.2185)] \\ &= \$214,273.20 \end{aligned}$$

Based on the above, the inputs for the Modified Valuation Model are:

$Np = 10$  or  $15$   
 $Nc = 5$  or  $10$  or  $15$  or  $20$   
 $R = 4.6\%$   
 $Tp = 21.85\%$   
 $Tc = 21.85\%$   
 $C = \$2,150,000$

$v = \$2,750,000$   
 $I_1 = \$225,000$   
 $I_2 = \$214,273.20$   
 $i = 5.0\%$

*The Calculation Results for Scenario 3*

The values of the estate freeze generated using the above inputs is set out in Table 6:

**Table 6 50 Unit Apartment Building and the Modified Valuation Model**

<b>50 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>V</u>	<u>Vt</u>	
10	15	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,651,177.83	\$1,243,447.87	
10	15	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,685,092.38	\$1,259,761.35	
10	15	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,729,706.56	\$1,281,221.53	
10	15	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,786,795.77	\$1,308,682.41	
10	15	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,858,371.65	\$1,343,111.63	
10	15	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,946,709.19	\$1,385,603.50	
10	15	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$3,054,376.60	\$1,437,393.37	

<b>50 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>V</u>	<u>Vt</u>	
10	20	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,268,247.29	\$1,576,843.51	
10	20	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,356,269.75	\$1,610,018.25	
10	20	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,473,466.90	\$1,654,188.63	
10	20	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,626,297.71	\$1,711,788.95	
10	20	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,822,424.46	\$1,785,707.06	
10	20	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$5,070,913.09	\$1,879,359.81	
10	20	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$5,382,464.02	\$1,996,780.08	

<b>50 Unit Apartment Building</b>											
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>V</u>	<u>Vt</u>	
10	25	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$6,483,283.09	\$1,882,717.47	
10	25	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$6,642,866.76	\$1,929,842.97	
10	25	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$6,860,854.41	\$1,994,215.32	
10	25	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$7,153,780.01	\$2,080,717.06	
10	25	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$7,542,275.96	\$2,195,441.00	
10	25	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$8,051,998.83	\$2,345,963.57	
10	25	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$8,714,748.62	\$2,541,675.42	

Table 6 50 Unit Apartment Building Continued

50 Unit Apartment Building												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
10	30	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$9,485,420.79	\$2,162,898.46	
10	30	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$9,739,383.58	\$2,221,659.72	
10	30	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$10,096,920.45	\$2,304,385.69	
10	30	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$10,594,278.80	\$2,419,463.20	
10	30	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$11,279,118.10	\$2,577,919.57	
10	30	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$12,213,819.73	\$2,794,188.45	
10	30	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$13,479,692.47	\$3,087,082.85	
50 Unit Apartment Building												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
15	20	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$4,603,182.35	\$1,703,077.01	
15	20	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$4,666,434.71	\$1,726,916.17	
15	20	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$4,762,502.25	\$1,759,354.11	
15	20	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$4,866,616.52	\$1,802,362.58	
15	20	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$5,015,029.32	\$1,858,297.81	
15	20	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$5,205,190.56	\$1,929,967.58	
15	20	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$5,445,954.17	\$2,020,708.85	
50 Unit Apartment Building												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
15	25	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$7,155,444.94	\$2,081,208.72	
15	25	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$7,319,628.71	\$2,129,692.65	
15	25	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$7,545,737.60	\$2,196,463.23	
15	25	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$7,851,019.83	\$2,286,613.92	
15	25	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$8,256,927.30	\$2,406,479.52	
15	25	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$8,790,054.01	\$2,563,913.31	
15	25	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.00	3%	5.0%	\$9,483,269.44	\$2,768,621.75	

**Table 6 50 Unit Apartment Building Continued**

<b>50 Unit Apartment Building</b>												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
15	30	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$10,586,407.32	\$2,417,641.92	
15	30	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$10,884,046.39	\$2,486,508.89	
15	30	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$11,304,231.76	\$2,583,730.30	
15	30	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$11,888,111.64	\$2,718,826.94	
15	30	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$12,689,269.11	\$2,904,196.71	
15	30	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$13,777,217.45	\$3,155,923.42	
15	30	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$15,241,820.76	\$3,494,799.60	
<b>50 Unit Apartment Building</b>												
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>C</u>	<u>v</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>i</u>	<u>V</u>	<u>Vt</u>	
15	35	4%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$15,166,194.81	\$2,717,669.78	
15	35	5%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$15,639,803.75	\$2,803,530.48	
15	35	6%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$16,328,219.48	\$2,928,333.57	
15	35	7%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$17,317,202.65	\$3,107,626.61	
15	35	8%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$18,724,024.71	\$3,362,669.78	
15	35	9%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$20,708,334.20	\$3,722,405.82	
15	35	10%	\$2,150,000.00	\$2,750,000.00	3.36%	\$225,000.00	\$214,273.20	3%	5.0%	\$23,486,572.87	\$4,226,073.50	

From Table 6 we again see the enormous potential of an estate freeze to increase family wealth. As in Scenario 2, but to a much greater extent, an estate freeze significantly adds to family wealth at all values for Np and Nc chosen for all growth rates, R, considered. The range of increase in wealth, Vt, (using a discount rate of 5%) is from a low of \$1,243,447 to a high of \$4,226,073.

Another positive benefit from performing an estate freeze, is that it allows the corporation to utilize the small business deduction. This again amounts to a tax “savings” of approximately \$58,000 annually. Unlike Scenario 2 discussed above, in this Scenario the corporation employs more than 5 full-time employees which means that it is eligible for

the deduction even if it generates income from property. In this regard, the reader will recall that a specified investment business will be considered as an active business provided it has more than 5 full-time employees. Also potentially available is the \$500,000 capital gains exemption subject to satisfying all necessary conditions.

Up to this point, recapture has not been considered in either Scenario 1 and 2. Therefore, in order to give the reader an appreciation of the impact of recapture on the calculations above, recapture has been considered for some of the values tabulated above. Given that recapture is date sensitive, the reader will note that recapture is calculated as of the date of disposition. Applying conservative recapture values,  $R_1$  and  $R_2$ , to some of tabulations in Table 6 we observe:

**Table 7 Recapture and Modified Valuation Model**

<b>50 Unit Apartment Building</b>										
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>R1</u>	<u>R2</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>V</u>	<u>Vt</u>
10	15	4%	\$50,000.00	\$25,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,670,808.66	\$1,252,890.63
10	15	5%	\$50,000.00	\$25,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,705,741.41	\$1,269,693.88
10	15	6%	\$50,000.00	\$25,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,751,413.33	\$1,291,662.86
10	15	7%	\$50,000.00	\$25,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,809,600.96	\$1,319,652.10
10	15	8%	\$50,000.00	\$25,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,882,317.10	\$1,354,629.81
10	15	9%	\$50,000.00	\$25,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$2,971,837.92	\$1,397,690.85
10	15	10%	\$50,000.00	\$25,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$3,080,732.84	\$1,450,071.17

<b>50 Unit Apartment Building</b>										
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>R1</u>	<u>R2</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>V</u>	<u>Vt</u>
10	20	4%	\$80,000.00	\$40,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,299,917.95	\$1,588,779.85
10	20	5%	\$80,000.00	\$40,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,392,001.73	\$1,623,485.26
10	20	6%	\$80,000.00	\$40,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,513,623.63	\$1,669,323.28
10	20	7%	\$80,000.00	\$40,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,671,271.27	\$1,728,739.01
10	20	8%	\$80,000.00	\$40,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$4,872,637.52	\$1,804,631.83
10	20	9%	\$80,000.00	\$40,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$5,126,820.95	\$1,900,430.90
10	20	10%	\$80,000.00	\$40,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$5,444,556.83	\$2,020,182.21

<b>50 Unit Apartment Building</b>										
<u>Np</u>	<u>Nc</u>	<u>R</u>	<u>R1</u>	<u>R2</u>	<u>Td</u>	<u>I1</u>	<u>I2</u>	<u>g</u>	<u>V</u>	<u>Vt</u>
10	25	4%	\$100,000.00	\$50,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$6,522,751.57	\$1,894,372.62
10	25	5%	\$100,000.00	\$50,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$6,691,828.85	\$1,944,301.61
10	25	6%	\$100,000.00	\$50,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$6,920,664.06	\$2,011,877.28
10	25	7%	\$100,000.00	\$50,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$7,225,968.68	\$2,102,034.58
10	25	8%	\$100,000.00	\$50,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$7,628,573.92	\$2,220,925.02
10	25	9%	\$100,000.00	\$50,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$8,154,358.72	\$2,376,190.73
10	25	10%	\$100,000.00	\$50,000.00	3.36%	\$225,000.00	\$214,273.20	3%	\$8,835,371.60	\$2,577,295.72

Comparing Table 7 to its corresponding values on Table 6, it is apparent that recapture has had very little affect on the value, Vt, of an estate freeze. Certainly, not enough of an effect to influence one's decision to perform an estate freeze.

Given the extraordinary ability for an estate freeze to generate wealth, as evidenced in Table 6, combined with the annual tax "saving" obtained by using the small business deduction and the potential for the children to qualify for the \$500,000 capital gains exemption, Mr. & Mrs. Taxpayer would be wise to implement an estate freeze.

## 12 CONCLUSION

An estate freeze is a powerful tax planning tool which can be applied by the unincorporated real estate owner to both preserve and generate family wealth. The enormous potential to generate wealth became particularly apparent from the application of the Modified Valuation Model to the selected fact scenarios 1 and 2. There are also other potential benefits which, as a consequence of implementing an estate freeze, may also be enjoyed. These include the utilization of the small business deduction and the \$500,000 capital gains exemption applicable to the disposition of qualified small business corporation shares.

The Modified Valuation Model, provides a method, subject to the assumptions made, to quantify the value of an estate freeze for the unincorporated real estate owner. This model will give an individual real estate owner a better appreciation of the benefits to be derived from an estate freeze and by so doing will contribute to the due diligence and decision-making process. On this point, I would speculate that many owners of real estate who stand to benefit from an estate freeze let the opportunity pass them by because of a lack of knowledge of the dramatic positive effect an estate freeze may have on generating family wealth.

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