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Tax

March 2021

An important tax strategy for cannabis business owners - Part 1

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One of the most common objectives of a successful business owner is to create an ownership structure which minimizes taxes and facilitates the transfer of wealth to the next generation. Several factors affecting the retail cannabis industry, including the nuances of the lottery process in Ontario, strict licensing requirements and the rush to obtain a first mover advantage have caused some owners to overlook the creation of an effective organizational structure.

Now, as retail experiences significant sales growth and entry into innovative partnerships with national brands, it is imperative for owners to ensure that their ownership structure is optimized from a tax and family succession perspective.

This article provides an overview of a popular tax planning technique for transferring ownership of a business known as an "estate freeze".

Reasons for implementing an estate freeze

The main reasons for implementing an estate freeze are tax-motivated. Generally, when you transfer property to your children, either during your lifetime or as a result of a deemed disposition on your death, you are subject to tax on the full amount of the accrued gain, even if you receive nothing in return for the transferred property. While an estate freeze cannot be used to shift a gain that has already accrued in the business to another person, the amount of the gain that is subject to tax in your hands can be capped by "freezing" the value of your shares without immediate tax consequences. This allows the growth to attach to new shares issued to your children.

An estate freeze is a particularly effective tax planning tool when used in combination with the lifetime capital gains exemption (LCGE). Under the LCGE, every individual is entitled to shelter up to $892,218 of capital gains on the sale of certain shares of qualifying corporations. Introducing new shareholders on an estate freeze can multiply the number of capital gains exemptions available on a future sale of the

business. For example, a freeze in favour of a spouse and three children, each of whom claim the full amount of the LCGE on a qualifying share sale, can result in tax savings of up to $954,673.

A family trust is frequently used to hold the growth common shares, particularly where minor children are involved. An article on the use of family trusts in tax planning will appear in a subsequent article.

In addition to the potential tax savings, an estate freeze can facilitate a transition of ownership and management to your children who would like to continue the family business after your death or retirement. A freeze can also be used to gift shares to a child outside of the community property regime which requires property to be shared with a spouse on a separation or divorce.

Whether an estate freeze is right for you will depend on your particular facts and circumstances. The optimal time to undertake an estate freeze is when the value of the business is expected to appreciate rapidly, or at a critical point in the life cycle of the business (such as transitioning to new management). On the other hand, there are circumstances when an estate freeze is not appropriate. For example, the objectives of an estate freeze will generally not be realized if the value of the business is expected to decline. In addition, adverse tax consequences may result if you are a U.S. citizen. Consequently, you should consult your tax advisor to determine whether an estate freeze is appropriate in your circumstances.

How an estate freeze works

There are several methods of implementing an estate freeze. The optimal method in each situation will depend upon a number of factors, including the existing ownership structure, whether you wish to participate in the growth of the business, whether you wish to retain control or turn it over to the new shareholders, and the availability of the LCGE. Your tax advisor will work with you to choose the method which best accomplishes your objectives. For illustrative purposes, we describe a common form of estate freeze below.

In this example, we are considering an individual (the “Freezor”) who owns all of the shares of a corporation that carries on a retail cannabis business. The first step of the freeze is for the Freezor to exchange their existing common shares (the “Old Shares”) of the corporation for fixed value preferred shares (the “Freeze Shares”). The transfer occurs on a tax-deferred “rollover” basis, so that for tax purposes the Freezor realizes no gain. Instead, the Freezor acquires the Freeze Shares at a tax cost equal to the tax cost of the Old Shares at the time of the exchange so that tax on the accrued gain is deferred until the time when they dispose of the Freeze Shares.

The Freeze Shares issued to the Freezor are redeemable and retractable, meaning that the Freezor and the corporation each have the option to trigger a sale of the shares back to the corporation. The amount payable on such a sale is equal to the fair market value of the corporation at the time of the exchange. This redemption feature fixes or freezes the value of the Freeze Shares at an amount equal to the value of the Old Shares at the time of the freeze. The Freeze Shares are also entitled to receive dividends up to a specified amount, and may carry voting rights which allow the Freezor to exercise control over the corporation.

As a second step, new shareholders will subscribe for new common shares of the corporation (the “Growth Shares”). The value of the Growth Shares will be nominal at the time of their issuance since the value of the business will attach to the Freeze Shares. The holders of the Growth Shares may include the Freezor’s spouse and children, a family trust, key employees, and the Freezor themselves.

The Growth Shares contain the rights to residual equity growth and dividend participation after the rights of the Freeze Shares are satisfied. Since the value of the Freeze Shares is fixed, all future growth will accrue to the Growth Shares.

Other factors to consider

The implementation of an estate freeze raises several important factors to consider, including the following:

1. Will you continue to participate in the growth of the business following the freeze? This will require an evaluation of whether your current assets are sufficient to fund your retirement needs.

2. Will you continue to control the business? This can be accomplished by issuing shares to you having voting rights that are sufficient to control the corporation. Also consider a successor plan for when you disengage from the business.

3. When is the best time to implement an estate freeze? One important factor to consider, particularly if a sale of the business in the near term is possible, is that new shareholders will generally have a two-year holding period to qualify for the LCGE. In addition, a freeze is only capable of shifting value to new shareholders which accrues from the date that the freeze is undertaken. As a result, effecting a freeze sooner than later may be recommended if the business is experiencing rapid growth.

4. Should new shareholders be allowed to sell their shares? You might want to consider entering into a shareholders' agreement to prevent new shareholders from selling their shares outside the family.

5. Obtaining a professional valuation of the business at the time of the freeze is critical protection against a future dispute with the Canada Revenue Agency.

6. Using a family trust to hold the growth shares can be an effective and flexible technique for you to retain control over the corporation and decision-making with respect to the growth shares and the income that those shares generate.

7. Consulting with a U.S. tax advisor is strongly recommended if you or any new shareholder is a U.S. citizen to avoid potential adverse U.S. tax consequences.

Finally, Canadian tax laws contain a number of complex rules and traps for the unwary which may thwart the objectives of an estate freeze. Consequently, consultation with an experienced tax advisor is essential to a successful restructuring.

This article was originally published on Business of Cannabis.

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