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Pitfalls in Estate Planning - Disarming the Succession Time Bomb

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Disarming the Succession Time Bomb: The Role of Trusts, Insurance, and Shareholders' Agreements in the Transition of Family Businesses*

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Abstract

The traditional estate freeze is often recommended to clients as a means of ensuring the tax-effective transition of a family business. However, unless advisers fully anticipate and provide for the practical considerations that can arise as the next generation takes over management and ownership of the family business, this tax planning can inadvertently set the family up for succession failure. In this paper, the authors provide a high-level discussion of the succession-planning objectives that an estate freeze is intended to address. They identify the common

* Although the main sections of this paper have been independently written, we have attempted to integrate them into a cohesive whole. The authors of the sections are as follows: Shelagh Rinald, "Introduction" and "Description of a Traditional Estate Freeze"; Ian Worland, "Uses of Trusts To Address Matters Contributing to Succession Failure"; Chris Ireland, "Uses of Life Insurance To Mitigate Succession Challenges"; and Glenn Stephens, "Shareholders' Agreements: Considerations in Mitigating Succession Challenges." Due to space limitations, our discussion of various "soft issues" is restricted. The provision for such soft issues is a critical component of an effective succession plan. These issues will be addressed more comprehensively by us at the Canadian Tax Foundation's BC Tax Conference (September 24-25, 2012).

pitfalls that are often overlooked in implementing an estate freeze and discuss how these pitfalls can contribute to succession failure. They also provide an analysis of how trusts, insurance policies, and shareholders' agreements can be used to maximize the chances of a successful transition.

Keywords Estate freeze; estate planning; trusts; insurance; shareholder agreements.

Introduction

Planning for the intergenerational transfer of a family business[1] is an area that has been subject to significant study over the years. The statistics that are often quoted in terms of the number of family businesses that survive the transition from one generation to the next[2] suggest that there remains a need to improve the nature and the application of the tools that are available to families in this regard. For the purposes of this paper, this improvement is contemplated relative to the degree to which family wealth and interpersonal relationships are maintained through the wealth transition or succession process. Various organizations[3] are rigorously researching tools to better address the interpersonal challenges that arise in the succession process and identify more effective ways of ensuring that families make use of these tools on a timely basis. In the meantime, the tools that are traditionally used to address the technical aspects of the wealth transition process and the potential contribution of those tools to the relative success or failure of the succession process has received relatively little attention.

One of the tools that is often touted as the key strategy for meeting a client's wealth transition objectives is the estate freeze. The estate freeze can help achieve various advantages from a succession-planning perspective; however, if the implications arising on the death of the founder[4] are not fully anticipated, the estate freeze can inadvertently become a significant contributor to succession failure. The desire to achieve certain income tax results and provide maximum flexibility during the lifetime of the founder can create unanticipated situations with respect to control of the business, ownership of the value associated with the business, and access to this value by shareholders, their creditors, and/or estranged spouses following the death of the founder.

The purpose of this paper is to illustrate the succession objectives that can be realized through a traditional estate freeze while (1) highlighting the technical matters that can contribute to succession failure if they are not properly addressed during the implementation stages and (2) providing possible solutions to these technical challenges. More specifically, this paper is divided into the following sections:

1) a description of a traditional estate freeze;
2) the use of trusts to address matters contributing to succession failure;
3) the use of life insurance to mitigate succession challenges; and
4) shareholders' agreement considerations in mitigating succession challenges.

These succession issues are often not effectively addressed during the implementation of an estate freeze because the founder, his or her family, and often his or her advisers may not be comfortable facing the potential conflicts that can arise between family members when these matters are discussed.[5] There is no doubt that the discussions can be stressful and that they require strong communication skills among family members. Often the assistance of a trained facilitator is required in order to ensure that family members' concerns are heard and addressed as part of the process.[6] In fact, the family communication challenges that arise in this regard can often foreshadow the reasons for succession failure that might otherwise arise following the death of the founder. On the other hand, the process of comprehensively implementing an estate freeze can lay the groundwork, from a communication perspective, for allowing the family to effectively discuss the various business issues that affect the family, and thereby increase the likelihood of succession success.

We want to emphasize the importance of addressing these succession challenges during the founder's lifetime, when—ideally—relations between family members are not emotionally charged and the founder's influence can be brought to bear in addressing the issues. At the same time the founder and his or her advisers must be prepared to persevere in seeing the process through, in spite of the potentially stressful discussions and strains on family relations.

Description of a Traditional Estate Freeze

Succession-Planning Objectives

As a founder begins to contemplate retirement, the transition of ownership and management of the family business and related estate-planning matters tends to begin to become a priority. On this basis, the founder will often approach his or her advisers—perhaps various advisers at various times—to discuss succession in general terms. It is essential at this stage that the advisers work with the founder and perhaps with the founder's family to clarify their succession objectives.

Without due diligence at this stage, the timer can be set on the succession time bomb. Often, the estate freeze proceeds from a technical perspective without a clear understanding of the objectives of the founder or the family for various reasons, including

- fee sensitivity,
- the adviser's reluctance to ask the difficult questions that are required to clarify the founder's objectives, and
- the founder's reluctance to face the difficult decisions that are required to clearly articulate his or her objectives.

Without perseverance on the part of the adviser and the founder and a willingness to put time and effort into working through these difficult decisions, the succession process can be completely derailed.[7]

In general terms, the founder's objectives will often centre on the following matters:

1) the transition of responsibility for the day-to-day operations of the business to the next generation;
2) allowing members of the next generation to participate in the future growth in value of the business in order to increase their interest in and commitment to the business, without exposing that value to the claims of creditors or marital or common-law spouses and while retaining flexibility in future distributions of that value;
3) retaining control over the business for the remainder of the founder's lifetime (or at least while he or she still has value invested in the business);
4) providing for the funding of the founder's retirement on a secure and tax-efficient basis;
5) providing for the financial security of the founder's spouse;
6) minimizing income taxes during the founder's lifetime and on death; and
7) minimizing the burdens and costs associated with the administration of the estate while ensuring that the founder's estate distribution objectives are met and that sufficient liquidity is available to pay any bequests and liabilities arising to the estate.

Often at the time that retirement is being contemplated, the founder will not have a clear sense of which, if any, of his or her children might be interested in being or qualified to be the successor. It may also be unclear whether the business will pass to the next generation or be sold to a third party. The founder will need to feel confident that the succession plan is flexible enough to accommodate changing circumstances over time. For the purposes of this paper, we have assumed that the purpose of the estate freeze is to assist with the transition of ownership of the business within the family, and, therefore we do not address in detail the myriad of issues that can arise in structuring a business for sale.[8] Although further elaboration could be provided on each of these objectives, due to space limitations the discussion in this paper has been limited to points 4, 6, and 7 in the list above.

Providing Retirement Funding on a Secure and Tax-Efficient Basis

Often, the value invested in the family business represents the founder's pension plan and his or her most significant source of cash flow. From this perspective, it is imperative to ensure that this source of funding is secure and can be accessed by the founder on a tax-efficient basis as needed. This objective becomes even more critical if the founder is to effectively hand over the reins to new management, because the founder must be confident that future cash flows are secure before he or she will be willing to effectively relinquish decision-making authority. Security takes the form of ensuring, to the extent possible, that the founder's nest egg is not exposed to future creditors of the business as new management comes into play. The founder must also be confident that the cash flows will continue to be accessible if he or she is incapacitated.

Various considerations are relevant in structuring the founder's retirement funding from a tax efficiency and financial security perspective. For example,

- maximizing income-splitting opportunities with a spouse, whether this is through the payment of dividends or the generation of pension income that is eligible for splitting with a spouse;[9]
- using a holding company to own passive investment assets;
- providing for the possible use of the capital gains exemption on the sale of shares to a third party or the sale or transfer of shares to family members; and
- taking advantage of the differential in tax rates between various sources of income, including salary, interest, dividends, and capital gains.

The founder's need for flexibility in the amount and timing of the cash flow from the business must be balanced with management's need to budget cash flows. This type of balancing requires planning and timely communication between the founder and management on an ongoing basis.

Maximizing Tax Efficiency

In addition to maximizing tax efficiency with respect to retirement cash flows, the founder will want to ensure that income taxes are minimized on the transition of ownership, whether to a third party or to family members, and on death. This planning can include the following steps:

- providing for the possible transfer of voting control of the company on a tax-efficient basis;
- maximizing capital gains exemption claims on the transfer of shares to third parties or family members;
- reducing the capital gains tax that would otherwise arise on the founder's death;
- deferring the capital gains tax that would otherwise arise on the founder's death; and
- ensuring that any double tax exposure that may exist with respect to the founder's private company shares following his or her death can be mitigated to the extent possible.

The founder will also want to ensure that the cash flow that is required to fund income tax, bequests, and other liabilities of the estate has been anticipated and provided for.

Ease of Estate Administration and Providing for Liquidity Requirements

The founder will want to ensure that the cash requirements of his or her estate have been anticipated and provided for. The cash requirements can include any of the following:

- funds to pay liabilities of the estate, including anticipated taxes;
- funds to pay bequests (including charitable gifts), particularly if business-related assets are to be distributed to certain children with the remaining children being equalized with other assets of the estate; and
- funds to cover any business-related exposure that could arise as a result of the founder's death, including cash flow implications arising from the loss of key supplier and/or customer relationships, the requirement to buy out other partners in the business, and/or the cost of covering any transitional period of management.

The founder may have various wishes with respect to the distribution of the estate, which often involve trying to equalize the estate between family members and ensuring that the value associated with the business passes along bloodlines. If the assets of the estate are primarily represented by the founder's investment in the business, careful consideration needs to be given to how the founder's equalization objectives can be met while preserving the value of the business, particularly if not all members of the next generation are involved in the business. Similarly, the funding of any buy-sell provisions with respect to business partners needs to be anticipated and provided for from a cash flow and tax-efficiency perspective.

Ease of estate administration is a key objective in order to ensure that the business can continue to be effectively and seamlessly carried on after the founder's death. In addition to ensuring that the necessary steps are taken from a business-planning perspective, the founder will want to ensure that his or her estate is protected from potential claims under applicable dependants' relief legislation.[10]

Example of an Estate Freeze Transaction

After reviewing the succession objectives of the founder, the adviser may recommend some form of estate freeze transaction as the best means of realizing those objectives. The actual structuring of the transaction will vary, depending on the specific objectives of the founder. In this paper, we do not review in detail the various methods of achieving an estate freeze.[11] Instead, we assume that the reader has an understanding of the alternatives and the technical issues that arise in the structuring of an estate freeze. With this understanding in mind, we use this section of the paper to provide an example of a typical estate freeze transaction in order to illustrate how the objectives of the founder can be achieved.

We also highlight the areas that are often not given due consideration and that can potentially contribute to succession failure.

Facts, Assumptions, and Succession Objectives

Assume that your clients, Victor and Nora Freeze, approach you in the fall of 2011 to discuss various estate-planning matters with respect to the family business, Freezeco. They want to step back from the day-to-day management of Freezeco over the next three to five years, while retaining overall control of the business. Their eldest son, Ice, has been working in the business for a number of years; ideally, he will be in a position to step into the CEO role over time.

You are aware of the following facts with respect to Victor and Nora's situation:

1) Victor and Nora are Canadian residents and citizens and are 65 and 64 years old, respectively. They are not citizens of any other country and have never been US residents or green-card holders.
2) They have three adult children, all of whom are Canadian residents and citizens:
   a) Ice is 40 years old and has worked in the business for a number of years. He is currently the operations manager. He is married and has two children aged 7 and 11.
   b) Slush is 38 years old. She is married and has three children aged 3, 7, and 10. She has not been employed outside the home since her children were born.
   c) Drip is 35 years old and has never been employed on a full-time or consistent basis. He has been living in a common-law relationship for the past two years. He has never been married and he has no children.
3) Victor and Nora each own 50 percent of the shares of Freezeco. The shares of Freezeco currently have a value of $4 million. Freezeco is a manufacturing business that has been very successful over the years and is currently beginning to accumulate cash for investment purposes. At present, approximately $1 million of excess cash is owned by Freezeco, which represents 15 percent of the value of the company's assets. Victor and Nora subscribed for their shares upon incorporation for $50 each.
4) Victor and Nora estimate that they require $150,000 per year before tax to live on. In addition to their shares in Freezeco, they own the following assets and have no debt:

Asset	*Fair market value*
Principal residence	$2,000,000
RRSP	$600,000

5) Their wills provide for their estate to transfer to the surviving spouse and then equally between their three children. Victor and Nora are the executors

of each other's estate; and if they are not able to act, Ice will act as the executor of their respective estates. The intention is for the children to continue to own the business with, ideally, Ice acting as CEO following Victor's and Nora's deaths. However, if Ice is not qualified to run the business or is not interested in running the business, the business will be sold.

6) In order to increase the children's commitment to the business, Victor and Nora want the children to begin to have an ownership interest in Freezeco. However, they are particularly concerned about their youngest son, Drip, and they do not want any portion of the value of the business to be exposed to creditor or marital or common-law claims of their children. They also want to ensure that the value associated with Freezeco can transfer only along bloodlines within their family.

The Estate Freeze Transaction

In order to freeze the value of Nora and Victor's interest in Freezeco and allow future growth in value of the company to accrue to the benefit of the next generation, the following steps will be undertaken on a general basis. It should be kept in mind that there are various ways of accomplishing an estate freeze, and that this proposed series of steps is one alternative. This example will illustrate the benefits and deficiencies from a succession-planning perspective that exist with respect to many estate freeze transactions. The example is not intended to provide a detailed discussion of the technical aspects of an estate freeze or document the technical tax matters that require review in implementing an estate freeze. These matters are covered elsewhere and are beyond the scope of this paper.[12]

It should also be noted that prior to implementing an estate freeze for a client, one must give careful consideration to the age of the founders and the financial resources otherwise available to them to fund their retirement.[13]

Step 1: Settle the Freeze Family Trust

The Freeze family trust is settled by Victor's sister,[14] Auntie Freeze, with a $100 bill. The funds to settle the trust come from the settlor, and in no circumstances is the settlor to be compensated for creating the trust. The $100 bill is attached to the trust documents until the trust is ultimately wound up. The attributes of the trust include the following:

- Victor, Nora, and Victor's close friend Ferris are appointed as the original trustees of the trust. The trust document provides that trustees can be removed and additional trustees can be appointed by Nora and Victor during their lifetimes. If neither Nora nor Victor is able to act as trustee, trustees can be added or removed with the unanimous consent of any remaining trustees. The majority of trustees must be Canadian residents at all times. The trust document requires a majority decision of the trustees. The trust document provides that no distribution can be made to a beneficiary at any time if the beneficiary is acting as the sole trustee of the trust.[15]

- The income and capital beneficiaries of the trust are Nora, Victor, and the issue of Nora and Victor. The beneficiaries include any trust whose only beneficiaries are also beneficiaries of the Freeze family trust or any company, as agreed to by the trustees, whose only shareholders are also beneficiaries of the Freeze family trust. The trust document specifies that no beneficiary is entitled to any income or capital from the trust at any time while they are under 18 years of age.[16]

  A company, Chillco, is incorporated. Nora and Victor each own 50 percent of the voting non-participating shares[17] and the trust owns 100 percent of the participating shares of Chillco. Chillco is a beneficiary of the trust.[18]

  The trust document makes it clear that no property held by the trust, or property substituted therefor, can be held on the condition that it may revert to the person from whom the property was directly or indirectly received (other than by operation of law) and that the trust cannot distribute trust property or substituted property to a corporate beneficiary from which it was received.[19]

  Other than the restrictions noted above, the trust is completely discretionary—that is, the distributions of income and/or capital from the trust are at the trustees' discretion in terms of their timing, amount, and beneficiaries.
- The trust document provides for the dissolution of the trust at any time at the trustees' discretion but no later than 80 years following the creation of the trust.
- The trust document provides that the settled funds (the $100 bill) cannot be disposed of during the existence of the trust, and that the settled funds must be paid out equally between all living beneficiaries upon the dissolution of the trust.[20]
- The trust document gives the trustees complete discretion in the management of trust assets.

The trustees open a bank account on behalf of the trust. The trustees arrange for the trust to borrow $60 from an arm's-length person (preferably a bank or other lending institution) on ordinary commercial terms without guarantees provided by any person, trust, or corporation. This borrowing requirement can be covered off, for example, by arranging for a limited overdraft on the trust's bank account. These funds are used to acquire shares of Freezeco (as outlined below) and are repaid upon the receipt of a dividend from Freezeco to the trust (also outlined below).[21]

Step 2: Amend the Share Capital of Freezeco

The share capital of Freezeco is amended, first, to rename the existing common shares "class Z common shares" and then to authorize the following classes of shares.

Sixty class A shares with the following attributes are authorized:[22]

1) The shares are voting non-participating shares with a par value of $0.10 per share.
2) The shares are redeemable by Freezeco for their par value.
3) The shares are retractable at the option of the holder (without any undue delay) for their par value.
4) The holders of the shares are entitled to receive the par value thereof and are not entitled to receive anything further on the liquidation or winding up of Freezeco. These shares rank behind all other classes of shares on liquidation or winding up.

Sixty class B common shares with the following attributes are authorized:

1) The shares are non-voting participating shares with a par value of $1.00 per share.
2) The shares are entitled to unlimited dividends. Dividends can be paid to the shareholders of the class B common shares to the exclusion of shareholders of all other shares.
3) These shares rank ahead of the class A shares but behind all other classes of shares on the liquidation or winding up of Freezeco.

Four million class C non-voting preferred shares with no par value are authorized.[23]

1) The shares are redeemable by Freezeco for an aggregate amount as set by the directors of the company equal to the fair market value of the class Z common shares transferred to the company on the share exchange.
2) The shares are retractable at the option of the holder (without any undue delay) for the same redemption value as set out above.
3) The shares bear a non-cumulative dividend rate of 5 percent. Dividends can be paid to the shareholders of the class C preferred shares to the exclusion of all other classes of shares. In the event of default by Freezeco on a request for redemption, the dividend rate becomes cumulative at a rate of 5 percent;
4) Freezeco is precluded from paying dividends on other classes of shares and from redeeming other classes of shares if such actions will result in insufficient net assets being available to redeem the class C preferred shares.
5) The shares have preference over all classes of shares on the liquidation or winding up of Freezeco.
6) A price adjustment clause is attached to the shares whereby the redemption value of the shares can be adjusted if the directors or some other competent authority with which the directors agree determines that the fair market value of the consideration received for the shares is something other than the amount as originally determined.[24]

Step 3: Share Exchange by Victor and Nora

Each of Victor and Nora exchanges his or her class Z shares of Freezeco for class A and class C preferred shares of the company pursuant to section 86 of the Act, as shown in table 1.

A share exchange agreement is prepared in order to document the exchange of shares pursuant to section 86. The share exchange agreement makes a reference to the price adjustment clause with respect to the class C preferred shares. The intention of this price adjustment clause is to provide for the event that the fair market value as specified in the agreement is successfully challenged by the Canada Revenue Agency (CRA) or another competent authority.

Step 4: Subscription for Class B Common Shares of Freezeco

The trust then subscribes for 60 class B common shares of Freezeco for $60.00. The funds to purchase these shares come from the borrowed money discussed in step 1 above.

Step 5: Transfer of Class C Preferred Shares to Chillco

Each of Victor and Nora transfers 500,000 of his or her class C preferred shares of Freezeco to Chillco for 500,000 class C preferred shares of Chillco with a redemption value equal to the redemption value of the Freezeco shares exchanged, pursuant to section 85.[25]

Step 6: Redemption of Class C Preferred Shares by Freezeco

Freezeco redeems the 1 million class C preferred shares owned by Chillco for $1 million using its excess cash balance.[26]

Step 7: Freezeco Pays a Dividend on Its Class B shares

One month later,[27] Freezeco pays a dividend of $5,000 on its class B common shares owned by the trust. Accordingly, the trust receives $5,000 in cash. The trust uses these funds to repay the funds borrowed for the share subscription discussed in step 4 above. The remaining funds are used to pay professional fees associated with the establishment of the trust and income taxes arising to the trust from the receipt of the dividend.

Step 8: Update of Victor's and Nora's Wills and Powers of Attorney

Victor and Nora put in place powers of attorney with respect to their voting shares of Freezeco and Chillco such that each will act as the other's attorney. If either one of them is not able to act, Ice will be appointed as the substitute attorney.

Their wills are updated to include a spouse trust[28] for the benefit of the surviving spouse. The wills otherwise remain the same in terms of the executors

Table 1 Exchange of Class Z Shares for Class C Shares

	Consideration given up					Consideration received		
Transferor	Description	ACB	PUC	FMV	Description	ACB	PUC	FMV
Victor	50 class Z shares of Freezeco	$50	$50	$2 million	50 class A shares of Freezeco	Nominal	Nominal	Nominal*
					2 million class C preferred shares of Freezeco	$50	$50	$2 million
Nora	50 class Z shares of Freezeco	$50	$50	$2 million	50 class A shares of Freezeco	Nominal	Nominal	Nominal*
					2 million class C preferred shares of Freezeco	$50	$50	$2 million

* The CRA's position with respect to the value of voting non-participating shares is discussed later in the paper.

of their respective estates and the distribution of the net assets of their respective estates equally between their three children.

Ongoing Considerations

For the remainder of Victor's and Nora's lifetimes, their cash flow can be funded by way of redemption of a portion of their class C preferred shares of Freezeco or Chillco such that the accrued gain in their preferred shares (and related taxes on the death of the survivor) will be reduced accordingly (subsequently referred to as "the wasting freeze transaction"). Alternatively, dividends can be paid through the trust, at the discretion of the trustees, to any of Victor, Nora, Ice, Slush, or Drip.

On the death of Victor or Nora, whichever is earlier, a spousal testamentary trust is created to hold preferred shares for the surviving spouse. The annual repurchase of preferred shares can continue for the surviving spouse's lifetime at low marginal tax rates due to the testamentary status of the spouse trust.

Estate Freeze Benefits: 10 Years Later

Circumstances of the Freeze Family in 2021

Assume that it is now 2021,[29] and the circumstances of the Freeze family are as follows:

1) Nora is terminally ill. Her illness is having a dramatic personal effect on Victor.
2) Victor is still fully responsible for the business, although Ice has assumed a senior management role.
3) The value of the common shares of Freezeco has increased to $5 million.
4) Victor and Nora have received their cash flow from Freezeco and Chillco through the redemption of their preferred shares, and they no longer hold any preferred shares of Chillco. The value of their preferred shares of Freezeco has been reduced to $2.5 million, held equally between the two of them.
5) Slush's husband left her in 2015, and she has been supporting her three children since that time with dividends from the trust.
6) Drip is single, has moved to the United States to avoid creditors in Canada, and remains unemployed.
7) No dividends have been paid by Chillco or Freezeco to the beneficiaries of the trust (other than to Slush, as noted above). Excess cash flow of Freezeco has been paid through the trust to Chillco over the years. The cash has been invested in real estate in Chillco such that the common shares of Chillco now have a value of $2 million.

Benefits of the Estate Freeze

The Freeze family has derived various benefits through the estate freeze, including the following:

1) In the absence of the estate freeze, Victor and Nora would have owned shares of Freezeco with a value of $9.5 million, and the income tax liability arising on the death of the survivor would have been approximately $2.1 million.[30] Instead, Victor and Nora hold preferred shares of Freezeco with a total value of $2.5 million[31] and a potential associated tax bill of $546,000 on the death of the survivor. It should be noted that the $1.6 million of tax deferral arising on the death of the survivor is relevant only if the shares of Freezeco continue to be held in the family following their deaths.[32]
2) Assuming that the shares of Freezeco qualify for the $750,000 enhanced capital gains exemption on the death of each of Victor and Nora, the related taxes on the death of the surviving spouse are reduced to $220,000.
3) With the reduction in the gain inherent in the shares held by Victor and Nora, the double tax exposure that is inherent in their preferred shares of Freezeco and Chillco following the death of the surviving spouse is reduced accordingly.[33]
4) If the shares of Freezeco are sold, an additional $2.25 million of capital gain can be sheltered from tax using the capital gains exemptions of Ice, Slush, and Drip (a tax benefit of approximately $500,000),[34] assuming that the shares meet the definition of qualified small business corporation (QSBC) shares at that time. In order to achieve this benefit, $375,000 of proceeds on the sale of the Freezeco shares by the trust must be made payable to each of the three children.
5) In the absence of the estate freeze transaction, the $2 million of excess cash flow of Freezeco would have remained invested in Freezeco[35] and exposed to its creditors.
6) Income-splitting advantages presumably have been realized through the dividend payments to Slush since her divorce. If Slush had no other sources of income, she could have received approximately $30,000 of ineligible dividends each year without incurring any income tax.[36]
7) On the assumption that no amounts were distributed from the trust to any of the children prior to Slush's divorce and no distributions have ever been made to Drip, the value in the common shares of Freezeco and Chillco held by the trust may have been protected from marital or common-law claims of their estranged spouses. Similarly, claims of Drip's creditors against the value of the shares held by the trust may have been mitigated.[37]

The Succession Time Bomb

When viewed at this level—which is often the perspective of the founder and his or her advisers—the estate freeze can be considered a success. For the purposes of this paper, however, the relative success of the estate freeze from a succession perspective is to be measured five years following the death of the founder. With that perspective in mind, the implications arising on the death of the founder and in the following five years need to be examined relative to the founder's succession objectives before the merits of the estate freeze can be properly assessed. On that basis, in spite of the benefits noted above, the estate freeze can inadvertently set the founder's family up for succession failure, as described more fully below.

Transition of Voting Control of Freezeco and Chillco

During any period in which Victor is incapacitated, Nora will act as Victor's attorney with respect to his voting shares of the companies. If Nora predeceases Victor or also becomes incapacitated, Ice will act as attorney with respect to the voting shares of the companies for the remainder of Victor's and Nora's lifetimes. Given Nora's present illness and the toll that it is taking on Victor, there may be a real possibility that Ice will assume control of the companies. This possibility raises the following concerns with respect to the estate freeze process:

- As further discussed below, the estate freeze process did not allow for any steps to be put in place for developing the readiness of Victor's successor to assume management responsibilities. Is Ice capable of taking on overall responsibility for the business on potentially very short notice? What signing authorities exist in the company? What other business-related issues affecting the continuity of operations can arise as a result of Victor's or Nora's incapacity?
- The estate freeze did not contemplate mechanisms for protecting the retirement cash flows of Victor and Nora during any periods of incapacity. As attorney for Victor and Nora, Ice may have voting control of the company and control over any request for retraction of their preferred shares. How and to what extent will Ice choose to fund his parents' cash flows?

An additional concern is the transition of voting control on the death of the surviving spouse. If the voting shares of the companies transfer equally to Ice, Slush, and Drip on the death of the survivor, as provided for in Victor's and Nora's wills, any two of the siblings will have effective control of the companies. The potentially divergent interests of the siblings could give rise to very significant, if not fatal, challenges from a succession perspective. For instance, Slush and Drip may be more interested in their need for immediate cash flow than in any business needs of the companies, while Ice may have a longer-term view of the financial health of the businesses. For these purposes, it should be kept in mind that the dividend payments on the preferred and common shares of the companies will be determined by the directors, who in turn will be appointed by a majority of the voting shareholders.

Alternatively, if, say, a majority of the voting shares were transferred to Ice, what protections are in place for the minority shareholders other than remedies through the courts? For instance, what recourse will the minority shareholders have to gain liquidity with respect to their shares (either in the form of dividends or through a sale) or access to information regarding Ice's compensation or taking action if Ice's compensation is excessive? Also, could the transfer of a majority of the voting shares to Ice give rise to wills-variation claims by Slush and Drip?

Transition of Preferred Shares of Freezeco

On the death of the survivor of Victor and Nora, their remaining preferred shares of Freezeco will transfer equally to Ice, Slush, and Drip in accordance with their wills. The preferred shares carry a retraction feature that allows the holder of the share to request redemption of the preferred shares at any time. On this basis, Slush and Drip, with their need for immediate cash flow, can request the redemption of their preferred shares of Freezeco at any time. This request has potentially significant financial implications for the company with the requirement to fund \$1.7 million within a very short period. If the shares are not redeemed when requested, the shares will carry a 5 percent cumulative dividend rate until they are redeemed. Again, such dividends will have implications for the cash flows of the business. The same implications can arise with respect to any shareholder loan balances transferred to any one of the siblings on the death of the survivor of Victor and Nora.

Can these implications be mitigated if the preferred shares are transferred to Ice with other compensation of an equal amount to Slush and Drip? This will require that at least \$5 million of liquid assets be available in the estate of the surviving spouse. It is unlikely that the value of the house and the RRSP after the estate's tax liabilities are paid will be sufficient to provide this liquidity.

Distribution of Income and Capital from the Trust

The amount, timing, and beneficiaries of any distribution of income or capital from the trust is completely at the discretion of the trustees. Neither Victor nor Nora can act as trustee during any period of incapacity. If Nora predeceases Victor, Ferris will be the only trustee of the trust for any period of Victor's incapacity and after Victor's death. Ferris could appoint additional trustees should he wish to do so.

As a result of the authority that is granted to Ferris, it will be up to him to determine how dividends from and the participating shares of Freezeco and Chillco are divided among Ice, Slush, Drip, and their children. In terms of realizing his fiduciary responsibility to the beneficiaries, Ferris is likely to maintain equal distributions between the families of Ice, Slush, and Drip. He will likely distribute the participating shares of Freezeco and Chillco equally among the three siblings soon after the death of the survivor of Victor and Nora and certainly before the 21st anniversary date of the trust. Regardless of the distribution proportions between the beneficiaries, various succession challenges can arise from this situation:

- Is Ice anticipating a more than proportionate allocation of the Freezeco shares, considering his contribution to the business over the years? Will he harbour resentment toward Ferris and/or his siblings as a result of a proportionate allocation?
- After the dissolution of the surviving spouse's estate and the distribution of shares from the trust, each of the siblings could own one-third of the voting and participating shares of each of the companies. There will be no restrictions on what the beneficiaries can do with their shares in terms of sale to a third party and/or a transfer outside of bloodlines. What are the implications for the respective businesses if any of the shares are sold to a third party or if any of the shares become exposed to creditor and/or marital claims of any of the beneficiaries?
- How will any of the siblings realize their value in either of the companies without the consent of at least one of the other siblings? Can Drip and Slush (acting as a controlling majority) order the liquidation of the corporate assets?
- How are business decisions and conflicts between the shareholders to be resolved, other than through a majority vote or through the courts?

Needless to say, a great deal of uncertainty exists with respect to the relationship among shareholders following the incapacity or deaths of Nora and Victor. This uncertainty can be a significant contributing factor to succession failure and deteriorating relations between the siblings.

Could the division of assets have been more effectively anticipated and provided for during Nora's and Victor's lifetimes in order to reduce the risk of succession failure? For instance, could the division of assets from the trust and through Nora's and Victor's wills have been coordinated such that the Freezeco value goes to Ice, with the interests of Slush and Drip being equalized with other assets of the estate? Alternatively, could the assets of Freezeco and/or Chillco have been divided on a tax-efficient basis during Victor's and Nora's lifetimes, such that the corporately held assets are better aligned to provide for the independent control of the assets by Ice, Slush, and Drip, respectively, following Victor's and Nora's deaths?[38]

Choosing a Successor and Developing His or Her Skills

As noted, the estate freeze process, as described, does not include any steps that assist in the process of identifying and training Victor's or Nora's successor, nor does it assist with the transition of these roles from a management perspective. Is Ice interested in taking over Victor's role in the business? Does Ice have the aptitude to do so? What skills does Ice need to develop in order to be able to take over the role, and how will he develop them? If Ice does not have the aptitude or is not able to develop the skills to take over Victor's role, how will a successor be found? Will Ice continue in the business under the leadership of a third party?

How will stakeholders—including employees, customers, and suppliers—react to new management?

With the effect of Nora's health issues on both Nora and Victor, the transmittal of the knowledge, contacts, and business acumen that is required for Ice to step into the role of CEO is not likely to be a significant priority or a feasible undertaking for either Nora or Victor at this time. Furthermore, these matters can take years to resolve and communicate to stakeholders effectively.[39] A lack of planning in this area is a significant factor contributing to succession failure for the Freeze family.

Liquidity of the Estate

In the structuring of the estate freeze transaction, anticipation of the cash requirements of the estate and the business as a result of the founder's death are often not given enough detailed attention. In the case of the Freeze family, even with the implementation of the estate freeze, certain cash flow requirements will arise on the death of the survivor of Victor and Nora, as noted below, and should have been anticipated through the implementation of the estate freeze:

- A tax exposure of \$220,000 (assuming that the preferred shares qualify for the capital gains exemption) still exists in the preferred shares owned by Victor and Nora. This tax exposure could be \$546,000 if the gain does not qualify for the enhanced capital gains exemption, or perhaps \$874,000 if the wasting freeze transaction has not been undertaken. Probate fees will also apply to the value of assets transferring to Victor and Nora's estate.[40] How will these cash requirements be funded?
- Without proper planning for Ice's skill development and his transition to the CEO role—including the related employee, supplier, and customer relationships—negative financial implications to the business on Victor's and/or Nora's death are likely inevitable. These implications do not appear to have been reviewed or provided for as part of the estate freeze transaction.
- As noted above, any of the subsequent owners of the preferred shares can request that Freezeco repurchase their shares at any time. How will the funds be generated to provide for these redemptions?

Meeting these cash flow requirements could well put significant strain on the finances of the business and relations between family members, thereby contributing to succession failure.

Ongoing Governance of the Business

At no point in the process of implementing the estate freeze was the ongoing governance of the business anticipated or provided for. Such governance issues include the following:

- How will directors be appointed during any period of incapacity of Victor and Nora and following the death of Victor and Nora?
- Who will be eligible to hold a position as a director of the company?
- If cash contributions by shareholders are required to fund the business, what terms will attach to such contributions? What are the implications if a shareholder cannot contribute?
- How will the compensation of family members involved in the business be determined? How will family members working in the business be evaluated?
- What rights will family members have to employment within the business?
- What level of management and financial reporting is required in order for the directors to monitor the effectiveness of management?

Similarly, during the process of implementing the estate freeze, no consideration was given to communicating the business issues that could affect the family. Such matters include the following:

- How will business issues that affect the family be communicated to family members who may have a financial interest but no day-to-day involvement in the business?
- How will the differing objectives of family members, members of management, and owners of the business be objectively dealt with?
- What mechanisms will the family members use to resolve controversial business issues that affect them?

If these governance issues are not fully addressed, the likelihood of succession failure is greatly increased for the Freeze family.

Other Matters

Various other matters will require review as a result of the passage of time and the changing circumstances of the Freeze family. These matters may or may not contribute to succession failure:

- the cross-border tax implications for Freezeco, Chillco, the trust, and Drip that arise from Drip's US residence;[41]
- the tax implications arising on the 21st anniversary date of the trust and the possible mechanisms for mitigating those implications while preserving the succession objectives of Nora and Victor;[42] and
- the post mortem planning that will be required on the death of Victor and/or Nora in order to mitigate the double tax exposure that may be inherent in their shares at that time.[43]

In the remainder of this paper, we describe certain techniques that can be used with respect to the drafting of the trust document and related materials, the structuring of life insurance, and the completion of effective shareholders' agreements to disarm the succession time bomb. It should be noted that these techniques can often be applied to existing estate freeze structures in order to reduce the risk of succession failure following the death of the founder. In fact, at a minimum, the potential succession issues associated with existing estate freeze structures should be brought to the attention of a founder whose family business could be in jeopardy if those issues are not effectively addressed during his or her lifetime.

Uses of Trusts To Address Matters Contributing to Succession Failure

Introduction

The trust is a flexible tool that is adaptable to suit many purposes; it is well established in the Canadian legal system, and is recognized by the Act. As is mentioned above, a discretionary family trust will typically be inserted into the ownership structure as part of an estate freeze reorganization. A discretionary trust can be used to achieve a number of objectives, including splitting income; deferring the recognition of gains beyond the death of a particular individual; proliferating capital gains exemptions; protecting assets from creditors (and, potentially, from estranged spouses); and avoiding probate fees. Provided that proper care is taken at the planning stage in the structuring of the trust, most or all of these objectives can usually be satisfied with little downside. However, too much flexibility can be as much of a problem as too little, so it is important to try to strike the right balance.

In this section of the paper, we discuss some tax and trust issues that should be considered in the drafting of a discretionary family trust in the context of succession planning for a family business such as Freezeco, and how decisions made in that regard can affect the success or failure of the succession plan.

Tax Issues Related to Trusts

Attribution Rules

Perhaps the first income tax issue to address in the establishment of a discretionary family trust is the potential application of the attribution rules in the Act. Care must be taken to ensure that there is no unwanted attribution of income earned in a discretionary family trust to a person from whom the property was received. This can be done by ensuring that the property is settled on the trust by a person who is sufficiently unrelated that there will be no attribution; by ensuring that the property used to settle the trust will generate no income; or, for those who prefer the belt-and-suspenders approach, by doing both. Until the benefits associated with making a preferred-beneficiary election were curtailed in 1994, it was typically desirable for a trust to be settled by a related individual (such as a grandparent), and it became common to use non-income-producing property, such as gold or silver coins or ingots, to settle trusts. When there is no need to have a related person settle a trust, it is often unnecessary to use a non-income-producing property, and it will often be convenient to settle a trust with cash. The cash can be used to pay professional fees associated with the settlement of the trust or to subscribe for shares of a company.

The attribution rules most typically relevant in family trust planning are set out in sections 74.1, 74.2, 74.4, and 75 of the Act. All of these rules have been thoroughly canvassed in other places,[44] and we do not review them in detail here. However, a few comments in relation to subsection 75(2) are in order.

Subsection 75(2) causes certain income and losses from property and taxable capital gains and allowable capital losses of a trust to be attributed to a person from whom the trust has received the property generating the income or loss or taxable capital gain or allowable capital loss, where certain conditions exist:

1) the property or property substituted for it may revert[45] to the person from whom it or the property for which it was substituted was directly or indirectly received;
2) the property or property substituted for it may pass to persons to be determined by the person from whom it or property for which it was substituted was received at a time subsequent to the creation of the trust; or
3) the property may not, during the lifetime of the person from whom it was received, be disposed of except with the consent or at the direction of the person from whom it was received.

In any case where a trust permits the distribution of capital to a contributor, the condition described in point 1 above will be present, and the attribution rule will apply. The condition described in point 2 will be an issue if the trust is discretionary and the person from whom the property was received is a trustee,[46] or if that person has a power to add persons to the class of beneficiaries. Finally, if a contributor is the sole trustee, is one of two trustees of the trust, or is one of three or more trustees of a trust without a majority rule clause, the condition described in point 3 will apply because the consent or direction of the settlor will be required to dispose of the property.[47]

It is important to remember that the attribution of income and gains is not the only consequence of the application of subsection 75(2) to a trust. Subsection 107(4.1) provides that if subsection 75(2) has ever applied to a trust, it is not possible for the trust to distribute property to a beneficiary on a tax-deferred rollover basis under subsection 107(2) unless the beneficiary is the person from whom the trust received the property that resulted in the application of subsection 75(2) (or property for which it was substituted) or is that person's spouse, while that person is still alive. If property cannot be rolled out of a trust, the benefits of an estate freeze may be significantly compromised; thus, it is important to take special care to ensure that subsection 75(2) will not apply to a trust. Some practitioners, in addition to drafting the terms of the trust to prevent the application of subsection 75(2), will include an express provision in the trust instrument that the trust should be construed to ensure that it does not apply.

Even if the provision itself is ineffective (for example, if it cannot be reconciled with another express clause that will make subsection 75(2) applicable), it may support a rectification application in the event that a problem is subsequently discovered.

The draft legislation released on October 31, 2011 includes a proposed amendment to subsection 107(4.1)[48] that will require subsection 75(2) to be read as though it applies even if the settlor is non-resident. That is, even if subsection 75(2) has never applied to a trust, if the reason for that is only that the settlor has not been resident in Canada at any time since the trust was settled, subsection 107(4.1) will deny a rollout of trust property to a capital beneficiary. This might be the case, for example, if the settlor reserved a power to add beneficiaries or could at some point be made trustee of the trust. The amendment is proposed to apply to distributions made after October 2011 and does not include any grandfathering provision.

These potential consequences of the application of the attribution rules illustrate the importance of taking special care in designing a trust to minimize the possibility that an attribution rule will apply to it.

Issues Relating to Control

A number of issues generally relating to control should be considered when one is structuring a trust that will hold shares of a private company. How each issue is resolved will be influenced by the objectives sought to be attained through the use of the trust, and the expectations that the planner may have with respect to what will happen in the future. In some cases, it will be most desirable to ensure that the small business deduction is available in the years immediately after the freeze; in others, it will be more important to ensure that capital gains exemptions can be proliferated among multiple beneficiaries; and in others, post mortem planning involving share redemptions or cost base bumps under paragraph 88(1)(d) will be more important. Although it will rarely be possible to achieve all of the objectives in a perfect way, with careful planning it will usually be possible to achieve a very favourable result.

Association of Companies

If a freeze is being carried out in the context of a group of related companies, it will be necessary to consider the association rules in section 256. These rules are relevant to a number of issues, most notably the availability of the small business deduction for income from an active business. The deferral that can be obtained through the lower tax rate applicable to income eligible for the small business deduction is significant. The 13.5 percent rate that applies to low-rate active business income of a British Columbia company is 13 percentage points (11.5 percentage points in 2012) less than income that is taxed in the corporation at the high 26.5 percent rate (25 percent in 2012), and 30.2 percentage points less than the 43.7 percent that a top-rate taxpayer would pay if the income were paid out as a bonus to a principal. Even when the lower 13 percent (11.5 percent in 2012) deferral figure is multiplied by the $500,000 business limit, a deferral of up to $76,000 ($57,500 in 2012) per year may be available to a private corporation that is not associated with another corporation.

Where the shares of the corporation are held in a discretionary trust, each beneficiary of the trust is deemed to own the shares held in the trust. If a husband and wife or a parent and child each own a company and the shares of the company are held in discretionary family trusts, there is a risk that the two companies will be associated, in which case they must share a single small business deduction. This situation does not arise in the Freezeco example used in this paper, so association issues are not discussed in detail here.

Affiliation Rules

Affiliation is the principal test for determining relevant relationships in the various stop-loss provisions of the Act. Of the greatest relevance to trusts is the stop-loss rule in subsection 40(3.6), which denies a loss when a taxpayer disposes of shares to a corporation and the taxpayer is affiliated with the corporation immediately after the disposition. In typical post mortem planning, the redemption or repurchase of shares following the death of a taxpayer is designed to generate a capital loss and deemed dividend, with the loss being carried back to use against a gain realized as a result of the deemed disposition of the shares on death.

"Affiliation" is defined in section 251.1. Individuals are affiliated with one another only if they are spouses or common-law partners.[49] Corporations are affiliated with persons by whom they are controlled, members of affiliated groups of persons by whom they are controlled, and spouses of such persons or members.[50] They may also be affiliated with one another if they share common control, or if they are controlled by affiliated persons or groups of persons each of whom is affiliated with a member of the other.[51] Section 251.1 also includes rules for determining the affiliation of partnerships with persons and other partnerships.[52] For all of these purposes, (1) persons are deemed to be affiliated with themselves,[53] (2) "persons" includes partnerships,[54] and (3) "control" includes de facto control.[55]

The affiliation of trusts is addressed in paragraphs 251.1(1)(g) and (h). Paragraph 251.1(1)(g) provides that a trust and a person will be affiliated if the person is a "majority-interest beneficiary" of the trust or would, but for that paragraph, be affiliated with a majority-interest beneficiary of the trust. Paragraph 251.1(1)(h) provides that two trusts will be affiliated with one another if a contributor to one is affiliated with a contributor to another and one of the following three conditions is met:

1) a majority-interest beneficiary of one trust is affiliated with a majority-interest beneficiary of another;
2) a majority-interest beneficiary of one trust is affiliated with each member of a majority-interest group of beneficiaries of the other trust; or

3) each member of a majority-interest group of beneficiaries of each of the trusts is affiliated with at least one member of a majority-interest group of beneficiaries of the other trust.

The terms "contributor" and "majority-interest beneficiary" are defined in subsection 251.1(3). A contributor to a trust is a person who has at any time made a loan or contribution to the trust, directly or indirectly, other than a loan made at a reasonable rate of interest or a transfer for fair market value (and then only if the person dealt at arm's length with the trust at the time it was made and was not a majority-interest beneficiary of the trust immediately afterwards). A majority-interest beneficiary is generally a person the value of whose interest, together with the value of the interests of all persons with whom the person is affiliated, in either the income or the capital of the trust is more than 50 percent of the value of all such interests in the income or capital, as the case may be, of the trust. For this purpose, a person who is beneficially interested in a trust[56] is considered to be a beneficiary under the trust.[57] Where the value of a person's interest in a trust is dependent on the exercise of, or the failure to exercise, any discretion by any person of a discretionary power, the power will be deemed to have been fully exercised or not exercised, as the case may be.[58] That is, each person who is beneficially interested in a discretionary trust will generally be a majority-interest beneficiary of the trust, no matter how remote the beneficiary's chances of receiving any benefit under the trust.[59]

The expansive definition of "majority-interest beneficiary" means that a trust holding shares of a privately held family company will typically be affiliated with the company. This will not be a concern for the Freeze family trust in our example, since the Freezeco shares that the trust holds have a low adjusted cost base and the trust will not have a deemed disposition of those shares on the death of Victor or Nora Freeze. However, if Victor transfers his Freezeco preferred shares to an alter ego or joint partner trust, the loss arising on a redemption of those shares by the company following his death will be denied by subsection 40(3.6).[60] Accordingly, special care must be taken to ensure that the impact of the trust affiliation rules is adequately considered when shares that belong to a trust and that have a high cost base and low paid-up capital are redeemed or repurchased. In some cases, this issue can be avoided by causing the trust to roll the shares that will be redeemed to a new holdco and then winding up the holdco. Paragraph 69(5)(d) provides that subsection 40(3.6) does not apply on a windup, so the loss will not be denied in this situation.[61]

Change of Trustees and Acquisition of Control

In our example, Victor and Nora Freeze have retained voting non-participating shares in the capital of Freezeco to protect their economic interests in the company. As has been mentioned,[62] this may give rise to valuation issues, although the CRA has indicated that in circumstances like these that will not usually be a concern. An alternative approach might be to attach the voting rights to the common shares held by the trust. If this is done, it will be necessary to consider what effect a change of the trustees of the Freeze family trust might have on control of Freezeco.

In determining who controls a company, it is necessary to look to the trustees of a trust that holds voting shares in its capital.[63] Accordingly, a change in the trustees of a trust holding voting control of a company may result in an acquisition of control of the company. Several adverse consequences can arise for a company that is so affected. Loss carryforward and other accounts may be restricted, and the deemed year-end, in addition to triggering a requirement to file an additional tax return and accelerating the expiry of unused losses, may accelerate deadlines for making or filing various elections, repaying shareholder loans, paying bonuses, and so on. Conversely, an acquisition of control may be a good thing when there is a desire to bump the cost base of corporate assets on a windup using paragraph 88(1)(d).

The CRA's view is that there will be an acquisition of control of a corporation on a change of one or more of three trustees holding a majority of the voting shares of the corporation, unless one of the relieving provisions in paragraph 256(7)(a) applies.[64]

However, it is possible that the CRA's analysis is too narrow. Suppose that the voting shares of Freezeco are held in the Freeze family trust; Victor is the sole trustee; and the trust instrument provides that on Victor's death, Ferris will become the trustee of the trust. Subsection 104(1) provides that a reference to a trust in the Act is to be read to include a reference to the trustee. The change in trustee on Victor's death is a transfer from one trustee (Victor) to another (Ferris) that is described in paragraph (f) of the definition "disposition" in subsection 248(1), and as such does not result in a disposition of trust property. Subsection 248(25.1) deems the new trustee (Ferris) to be the same trustee as, and a continuation of, the old trustee (Victor) for most purposes of the Act. Since the new trustee is the same, and a continuation of, the original trustee, there is no acquisition of control when the settlor dies and the adviser becomes the trustee.[65]

Just as it is important to ensure that there is no change of control in situations where such a change is undesirable, in instances where a change of control on death is desirable (that is, where a paragraph 88(1)(d) bump will be utilized), care should be taken to ensure that there will be a change of control as a consequence of the death of an individual. So that there is no question about who controls the company, shares in a trust should be distributed from the trust to one or more beneficiaries, even when the trustees of the trust will change as a result of the death.

Capital Gains Exemptions

Discretionary trusts can be used to proliferate the capital gains exemption by enabling the taxable portion of gains realized on the sale of QSBC shares, qualified farm property, or qualified fishing property (referred to herein as "qualifying properties") to be distributed among and designated to multiple beneficiaries.[66] If the trust realizes a capital gain and makes the appropriate designations under subsections 104(21) and (21.2) designating the resulting taxable capital gain to an individual beneficiary, the beneficiary will be able to use his or her capital gains exemption to shelter the gain. Conveniently, only the taxable portion of the gain needs to be made payable to the beneficiary, so a trust that realizes a $750,000 capital gain that is eligible for the capital gains exemption can pay the taxable portion to the beneficiary (who will claim the exemption) and retain the balance for reinvestment or distribution to a different beneficiary. Thus, by freezing a company into a discretionary family trust, a client can achieve the flexibility to make use of multiple capital gains exemptions while preserving the flexibility to decide how to do so until the year in which the gains are realized.[67]

Our example does not discuss the possibility that the Freezeco shares will be sold to a buyer in circumstances that might allow the resulting gains to be sheltered using the capital gains exemption. Indeed, the premise of the example is that the objective is to successfully pass the business to the next generation. However, it is important to ask the client about the possibility of a sale and to consider the extent to which that possibility should be provided for in the planning. If a sale is a possibility, the composition of the class of beneficiaries of the trust might warrant additional consideration. It may not be necessary to include all potential beneficiaries from the outset. It appears than an individual will be entitled to claim the capital gains exemption in respect of gains allocated out to the individual even if he or she was not a beneficiary under the trust throughout the 24 months immediately preceding the sale of the relevant property by the trust, but is added to the class of beneficiaries shortly before or even after a sale of shares.[68] Although the capital gains exemption is still available to shelter gains arising on an arm's-length sale of QSBC shares by a trust and allocated out to a minor beneficiary without the application of kiddie tax, in our example the grandchildren of Victor and Nora Freeze are not permitted to benefit under the trust while they are under 18 years of age. If Victor and Nora want to keep open the possibility of allocating capital gains arising on the sale of Freezeco shares out to the grandchildren, it may be necessary to consider other ways of dealing with the potential application of section 74.4.

Investment Holding Companies

The Freeze family trust can also be used to flow dividends up from Freezeco and down to Chillco, which is a beneficiary of the trust. Provided that the trust designates the distribution to Chillco under subsection 104(19), the dividend will be deemed to have been paid from Freezeco to Chillco and will be fully deductible by Chillco under subsection 112(1). Provided that the ownership of the companies is such that they are connected for the purposes of section 186, no part IV tax will be payable on the dividend.[69] This will allow the family to enjoy the deferral of tax on income that is retained in the corporate structure while at the same time moving excess earnings to a separate company. This will make it easier to keep Freezeco pure for the purposes of the capital gains exemption, and it will protect the dividends from Freezeco's liabilities. Because Freezeco is not a subsidiary of Chillco in this structure, the capital gains exemption can be used on a sale of the shares of Freezeco, provided that it is otherwise available.

It is common in this type of planning for the trust to hold shares of the holding company (thus providing flexibility in the distribution of its shares and of dividends or gains derived from them) as well as for the holding company to be a beneficiary of the trust. Subsection 75(2) is probably not a concern in such structures.[70]

As is mentioned above, care must be taken to ensure that the two companies are connected. If the persons who control the operating company (here, Victor and Nora control Freezeco) do not hold a controlling interest in the operating company (for example, if they were to hold only a minority position), this common control may not be present. One solution is to ensure that the trustees hold the voting shares of both the operating company and the investment holding company, and to cause the trust to roll its shares of the operating company into a holding company so that the holding company and the operating company are connected by virtue of the 10 percent votes and value test and the holding company is connected to the investment holding company by virtue of common control.

The 21-Year Deemed Disposition

One of the basic limitations on the use of trusts is the deemed disposition provision in subsection 104(4). Many people treat this rule as equivalent to a 21-year limit on the useful lifespan of a trust. This is not always desirable—for example, where the principals of a corporation have frozen at an early stage, and as the 21st year anniversary approaches are still active in the business and are not yet ready to distribute the common shares to the next generation. Sometimes trust instruments even provide for a vesting date shortly before the 21st anniversary of the settlement of the trust, precluding the possibility of a longer trust period and limiting flexibility.

However, provided that integration can be achieved on the corporate income, there may be opportunities to prolong the useful lifespan of a trust and avoid the need to effect a substantial transfer of wealth to prevent the 21-year deemed disposition. By carrying out estate freezes at more frequent intervals—say, every 7 years—it is possible to reduce the amount of the gain that must be dealt with on any given 21-year disposition. Better yet, if there is full or close to full integration on the distribution of the company's income, and each successive freeze is designed as a wasting freeze, the gains accrued in any particular trust may be completely eliminated before the 21-year anniversary of the settlement of that trust arrives. This approach works particularly well when the income of the underlying company is investment income and the refundable dividend tax on hand (RDTOH) refund approximates the resulting tax at the trust or individual level, but it may work when a substantial portion of the company's profits from an active business are also distributed. If the freeze shares received by a trust in, say, the 7th year of its existence have been fully redeemed by the 21-year deemed disposition and the proceeds have been invested in portfolio investments that are regularly turned over, the tax liability associated with the accrued gain in the portfolio may be manageable enough to justify leaving the trust in place and accepting the consequences of the deemed disposition. Or, if the freeze shares have not been fully redeemed, it may be possible to distribute the remaining shares to the members of the next generation who will be moving forward with the business while at the same time setting aside other trust property for a different family member who is not yet considered ready for a significant distribution. If the other trust property that is set aside is tax-paid or has minimal gains, it can be left in the trust, thus deferring the need to distribute it.

A trust (other than an alter ego trust, joint partner trust, spousal trust, or self-benefit trust) will generally not be subject to the deemed disposition rule in subsection 104(4) if it is a trust in which all the interests have vested indefeasibly.[71] Thus, the trustee of a testamentary trust other than a spousal trust can avoid the application of the deemed disposition by simply fixing the interests of the beneficiaries without actually making a distribution. This will not be the case where the trust is resident in Canada and more than 20 percent of the value of all the interests in the trust is held by non-residents.[72] This would preclude the vesting of the interests in the Freeze family trust in Ice, Drip, and Slush in equal shares to avoid a 21-year deemed disposition.

US Beneficiaries

A comprehensive discussion of the impact of having US beneficiaries of the Freeze family trust is beyond the scope of this paper (and the qualifications of its authors). However, it is critical that this impact not be disregarded, and proper advice should be sought wherever a trust includes one or more US-resident beneficiaries.

In our example, Drip is living in the United States. Some of the issues that should be considered in relation to Drip's residence include the following:

- The potential application of tax under part XII.2 of the Act if the Freeze family trust has any designated income. Part XII.2 tax applies at a rate of 36 percent on the designated income of a trust (other than a testamentary trust) resident in Canada if it has one or more non-resident beneficiaries and distributes designated income to any beneficiary (including a resident beneficiary) in the year. Generally speaking, designated income includes taxable capital gains arising from the disposition of taxable Canadian property, income from real property situated in Canada, and income from a business carried on in Canada. None of these are present in our example, so part XII.2 tax should not be a concern.

- Most types of property cannot be distributed to a non-resident beneficiary on a tax-deferred rollover basis under subsection 107(2).
- Withholding tax under part XIII of the Act will apply to most distributions of trust income made to a non-resident beneficiary.[73]
- A beneficiary resident in the United States may be subject to income tax under the Internal Revenue Code[74] on distributions made to him or her. If the distribution is considered for US purposes to be made out of "undistributed net income" from a prior year, it may be allocated to a prior year and subjected to compound interest at prescribed rates, resulting in a tax bill equal to 100 percent of the distribution.
- The beneficiary may be subject to onerous compliance obligations, including the obligation to file form 3520 ("Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts").
- In certain circumstances, the interest in the trust may be included in the beneficiary's gross estate for the purposes of US estate tax.

Some of these considerations will be relevant not only when a beneficiary is a US resident, but also when a US citizen or green-card holder is a beneficiary, whether resident in the United States or otherwise.

Non-Tax Issues Related to Trusts

Beneficiaries

Who Is a Beneficiary?

Typically, a trust instrument will identify the class of beneficiaries by naming certain individuals and including others who have a certain relationship (child, issue, spouse, etc.) to one or more of the named individuals. Sometimes a company will be included as a beneficiary.[75] For most purposes, the persons and members of the classes of persons so identified will be considered the beneficiaries of the trust. However, it is important not to lose sight of the definition "beneficially interested" in subsection 248(25); in general terms, it provides that for the purposes of the Act a person is beneficially interested in a trust if the person is not otherwise beneficially interested in the trust but might become so and is within two degrees of arm's length of a person from whom the trust has acquired property. As a result, many people who are not beneficiaries of a trust but who may be added to the class of beneficiaries will be considered to be beneficially interested in the trust for the purposes of the Act.

Powers To Add and Remove Beneficiaries

Trust instruments often provide a mechanism by which people who are not named or identified as beneficiaries can be added to the class of beneficiaries. This power might be held by the trustee, one of the beneficiaries, or a protector.[76]

It is important to consider whether the addition or removal of a beneficiary will result in the disposition by any beneficiary of an interest in the trust, and if so whether the disposition may result in a tax liability. Despite the CRA's statements to the contrary,[77] the better view is probably that the value of a beneficiary's interest in a discretionary trust is negligible, so the addition or removal of a beneficiary should generally not result in any tax consequence.

Distributions and Transfers

Pay To or For the Benefit Of

It is important to give careful consideration to the actual language used in a trust instrument. A common form of language allows the trustee to pay or transfer trust property "to or for the benefit of" the named beneficiaries. In *In re Pilkingtons' Will Trusts*,[78] the House of Lords considered a trust that used similar language. Although the distribution under consideration in that case was not approved for other reasons, the reasons given by the House of Lords make it clear that trust property can be distributed to a new trust, the beneficiaries of which include not only one or more of the beneficiaries of the original trust but also others, if that can be considered a benefit to the original beneficiary. Thus, it may be possible to expand the class of beneficiaries under a trust by appointing trust property to a new trust (perhaps under subsection 107(2)) with a wider class of beneficiaries.

In our example, the language might have been used to facilitate the distribution of trust property to a subtrust for the benefit of, say, Ice and Slush to the exclusion of Drip, or to a subtrust that includes an unlimited liability company or other entity for the benefit of Drip.

Although in certain circumstances the flexibility that this type of language allows will be helpful, in others it may be unwelcome. For example, the language is likely to significantly widen the class of persons who may be beneficially interested in a trust under the expanded definition of that term in subsection 248(25).

Power To Appoint Property

It is typical for discretionary trusts to be drafted so that they are completely discretionary during the trust period, with a specific distribution to be made only on the final distribution date. That date may be 80 or more years after the trust was established. Wills do not generally govern the distribution of property held in a trust.

In our example, when Victor and Nora have both died, the remaining trustee will be their friend Ferris. He may have a letter of wishes to which to refer. If he does not, he will in all likelihood aim for fairness, and hope to avoid litigation, by deciding to distribute the trust property equally among the children. Either way, however, the ultimate decision is his to make, which may mean that he has more flexibility than is appropriate. An alternative is to include specific terms for the distribution of trust property after the death of a certain person—here, that presumably will be the survivor of Victor and Nora. However, unlike a will, a trust used in an estate freeze is not ambulatory—that is, it is effective from the day it is made and cannot generally be revoked or rewritten, at least not easily.

A simple solution is to design the trust so that someone has a power of appointment, exercisable by a deed, will, or other instrument, which allows that person to direct the distribution of the trust property on a given event. For example, the trust might confer a power of appointment on the survivor of Mr. and Mrs. Freeze. This would allow them the flexibility to direct how the trust property should be distributed after their deaths without having to rely on the successor trustee to make the right decisions; at the same time, it does not lock them into a fixed distribution at the time the trust is created.

Powers of appointment are generally categorized according to the class of potential beneficiaries in favour of whom the property subject to the power may be appointed, as follows:

- A general power is a power to appoint property in favour of anyone, including the donee or holder of the power. Property that is subject to a general power may be considered to form part of a person's estate, exposing it to probate fees, claims under dependants' relief legislation, etc.[79]
- A special power is a power to appoint property in favour of a limited class of persons defined or specified in the trust instrument. Property subject to a special power does not form part of a person's estate.
- A hybrid power is a power to appoint property in favour of anyone except a specified class of persons—that is, "anyone other than." Property subject to a hybrid power does not form part of a person's estate. A hybrid power allows most of the flexibility of a general power while preventing the trust property that is subject to it from being included in the donee's estate and thus exposed to probate fees, claims under dependants' relief legislation, etc.

The dual objectives of ensuring that the trust property is not considered to be part of the estate of the person holding the power and allowing the greatest possible flexibility will often militate in favour of a hybrid power. Such a power might be conferred on Victor by using language along the following lines:

> Upon the death of Mr. Freeze, the trustee shall stand possessed of the income and capital of the trust fund upon such trusts (including discretionary trusts) in favour of such person or persons (other than Mr. Freeze, Mrs. Freeze, their personal representatives, their creditors or the creditors of their estates) exercisable by such person or persons as Mr. Freeze may appoint by a testamentary instrument provided that such testamentary instrument contains an express declaration that it is intended to exercise this power.

Transfers to Other Trusts

Sometimes it will be necessary to determine whether an appointment of trust property creates a new trust or whether it should be treated merely as an allocation of property within the existing trust. For example, if the Freeze family trust does not include a power of appointment such as the one described in the previous section, the trustees might consider appointing the trust property to be held by them on terms that are identical to the terms of the existing trust, except that such a power of appointment is exercisable by Victor. If this is a transfer or disposition of the trust property to a new trust, it will be necessary to determine whether a rollover is available—for example, under subsection 107(2) or section 107.4. Some case law that might be relevant to a consideration of whether there is a transfer to a new trust includes *Bond (Inspector of Taxes) v. Pickford*[80] (whether a "deed of allocation" created separate settlements resulting in a disposition); *Muir or Williams v. Muir*[81] (effect of the exercise of a limited power of appointment); *IRC v. Jamieson*,[82] (whether a power in a settlement to appoint the whole of the trust fund for the benefit of certain beneficiaries would result in a "determination" of the settlement); and *Roome v. Edwards*,[83] and *In re Pilkington's Will Trusts*[84] (discussions of the distinction between trusts and settlements and the indicia of each).

Other Powers

Power To Amend

As will be evident from the foregoing discussion, a discretionary trust will often be flexible enough to be adapted to suit changing circumstances through the powers to appoint property conferred on the trustees or others, the powers to add and remove beneficiaries, and so on. However, these powers are sometimes not enough or are too cumbersome to use. A power to amend the trust instrument may offer another option. Provisions allowing for the amendment of a trust can be limited to administrative provisions only, or they can extend to any or all of the substantive terms of the trust. However, it is crucial that they be carefully considered and drafted. For example, a power to amend the substantive terms of a trust that is reserved by the settlor may result in the application of subsection 75(2) if the power allows the settlor to make a change that permits trust property to revert to him or her or to add additional persons to the class of beneficiaries.

Power To Remove and Replace Trustees

The Freeze family trust allows Victor and Nora to remove and replace trustees during their lifetimes. Presumably, the terms also provide that if one of them lacks capacity or has died, the other will be able to exercise the power to remove and replace trustees alone. The trust also provides that the remaining trustees can appoint new trustees by unanimous decision. Other options include conferring on a protector who is not a trustee (and perhaps also not a beneficiary) the power to remove and replace trustees; allowing the beneficiaries to name a new trustee (for example, by majority decision of the adult capacitated beneficiaries); or simply naming a series of successor trustees and the circumstances or combinations under which they might ascend to the position. There is no single right answer, provided that the document makes clear provision for the succession of trustees. An issue that we have encountered on more than occasion relates to the time when an appointment by a protector will be effective: is it necessary for the appointment to be immediate, or can it be made effective on the occurrence of some future event or the satisfaction of some condition (and if so, is it subordinate or does it have primacy over other provisions for the appointment of trustees)? The number of requests we have encountered for such a power to make a "springing appointment" suggest that it is worth considering including one almost as a matter of course. It is prudent to prescribe the mechanism by which a trustee will be removed or appointed—for example, by written deed signed by the appropriate parties and attached to the original trust instrument.

Of course, a protector may become unwilling to act, may lose capacity, or may die, so issues of succession should be considered for both the protector and the trustee. Where a trustee or protector is to cease to act on incapacity, the manner in which the incapacity will be adjudged should be set out in the trust instrument.

Family Relations Issues

Family law, at least insofar as it involves the division of property on marital breakdown, is largely a matter of provincial jurisdiction, and a complete discussion of the applicable rules in each of the provinces is far beyond the scope of this paper. However, it is worth mentioning here a few points about the application of the law in British Columbia to trusts. Generally, the current British Columbia Family Relations Act[85] provides that on the breakdown of a marriage each spouse is entitled to an undivided one-half interest in the family assets.

There are a number of ways in which an in interest in a trust or property subject to a trust can be subject to a property division claim under the Family Relations Act on a marriage breakdown. The beneficial interest of a spouse in the trust property can become a family asset for purposes of the Family Relations Act in two circumstances: (1) if it is ordinarily used by a spouse or a minor child of either spouse for a family purpose,[86] and (2) if property subject to the trust under which the spouse owned the beneficial interest would be a family asset if it were owned by the spouse.[87] A beneficial interest in trust property can also be subject to an order made by a court under section 65(2) of the Family Relations Act.

The trust property itself may be subject to a property division claim under the Family Relations Act (1) if the property itself would be a family asset if it were owned by a spouse and the spouse has, either alone or together with another person, a power of appointment exercisable over the trust property in favour of himself or herself,[88] or has disposed of the property but has the power, either alone or together with another person, to revoke the disposition or to use or dispose of the property,[89] and (2) if the trust property is subject to either an antenuptial or postnuptial settlement.[90]

Uses of Life Insurance To Mitigate Succession Challenges

Life insurance can be a valuable tool to assist in a number of the succession challenges that can arise for a business-owning family such as the Freezes. In this section of the paper, we review the liquidity needs for a private business, some of the basics of corporate-owned life insurance, the post mortem planning opportunities and tax efficiencies that can result from corporate-owned insurance, and the use of life insurance with a wasting freeze.

Liquidity Needs

One of the succession challenges for a privately held business is dealing with the liquidity requirements that can arise on the death of a shareholder. The most immediate liquidity concern is usually the taxes arising on the fair market value deemed disposition of the shares in the corporation. The timing of the disposition may depend on whether or not the deceased left a surviving spouse. In our example, it is assumed that the first to die of Victor and Nora will have an appropriately worded will so that a spousal rollover of the preferred shares will result.[91]

In addition, liquidity or other assets may be needed to provide for a so-called estate equalization—the distribution of non-business assets to children or other beneficiaries who are not involved in the business. In many cases, the estate equalization may come from a repurchase of the parents' preferred shares. If liquidity is not available, and depending on the terms of any family shareholders' agreement (discussed later in the paper), the continued ownership of the preferred shares by family members who are not actively involved in the business could be problematic. Assume that the Freeze family has considered its liquidity options and has made the decision to use corporate-owned life insurance.

Capital Gains Tax

To determine the liquidity need for the payment of taxes on death (in respect of the preferred shares), the first step is to complete some pro forma post mortem planning—that is, assume that Victor and Nora die tomorrow with corporate-owned insurance equal to the amount of capital gains taxes. Because a capital dividend account will arise from the receipt of the insurance,[92] appropriate post mortem planning can be implemented, resulting in a decreased tax bill. To illustrate, assume that the Freezes want to insure the tax on the $4 million of preferred shares (here, we assume that a wasting freeze will not be implemented). Using the highest marginal rate in British Columbia, the taxes would be $874,000 (43.7 percent multiplied by 50 percent of a $4 million capital gain). However, after the death of the second to die of Victor and Nora, the post mortem planning could consist of implementing the 50 percent solution for the capital dividend account resulting from the receipt of the insurance proceeds (with a full capital dividend account credit assumed for the receipt of the proceeds), together with preservation of the capital gains rate for the balance of value.[93] The result would be approximately $790,000 of taxes rather than $874,000, a decrease of almost 10 percent.

This result and calculation can be put into a formula as follows:

> Tax after post mortem planning = Tax otherwise payable/1 + (MTR − DTR),
> where MTR is the marginal tax rate (interest or salary income) and DTR is the dividend tax rate.

The message is that if the only liquidity to be provided by the corporate-owned life insurance will be for the capital gains tax, the amount should be less than originally anticipated due to the post mortem planning that should be undertaken after the death of the second to die of Victor and Nora.

If Victor and Nora complete at least part of the planned wasting freeze as reviewed earlier in the paper, the expected tax bill will decline over the years. The topic of using life insurance in the context of a wasting freeze is addressed below under the heading "Dealing with the Wasting Freeze."

Estate Equalization

The use of life insurance to facilitate some form of estate equalization is often encountered in situations where not all of the children are involved in the family business. A number of questions must be asked to determine the best use of the insurance and just how much coverage may be required. For the Freeze family, the following questions should be considered:

- What are the intentions of the family with respect to the preferred shares after the death of the parents? The tax savings and opportunities with corporate-owned life insurance and the repurchase of the preferred shares after the deaths of Victor and Nora are reviewed below under the heading "Post Mortem Planning Opportunities."
- What other assets are owned by the parents? What are the testamentary intentions with respect to those assets?
- Will a portion of the value associated with the shares, but not the shares themselves, pass to non-active children? If that is the case, the family may

want to consider having those shares subject to a mandatory buyout (documented in a shareholders' agreement), since Ice may not want his siblings as business partners. Any shares passing to a child active in the business may not be subject to such a repurchase, although the liquidity needs of the children involved in the business must still be considered.

- Will any common shares pass to the non-active children? At present, the common shares for the Freeze family are held in a discretionary inter vivos trust.
- What are the implications of the wasting freeze on the estate equalization issues? Should there be a reduction in the amount of the life insurance to accommodate the reduction in preferred shares, or should the "extra" life insurance be used for estate equalization purposes in any event? Note that the "extra" insurance proceeds could be distributed tax-free to the non-active children via the family trust (even if the non-active children do not eventually receive any common shares from the trust).

Corporate-Owned Life Insurance

A number of issues need to be addressed by the Freeze family when they consider the purchase and funding of life insurance. The starting point is to determine the owner and beneficiary of the policies. Because life insurance premiums are not deductible in most situations,[94] it will be cost-efficient to have the policies owned, or at least the premiums paid, by the low-rate taxpayer—in the family business context, this means that the premiums will be funded by a corporation out of low-rate business income if applicable. For the Freezes, this can mean having Freezeco fund the premiums, assuming that the company earns business income (whether or not it is eligible for the small business deduction). Although it may not be desirable for Freezeco to actually own the policies (there can be other considerations affecting ownership, such as creditor protection issues and providing for flexibility with respect to future ownership of the policy),[95] the funding can still come from Freezeco by way of dividends. Once there is sufficient value in the common shares, Freezeco can pay dividends to the trust as the common shareholder, with the trust distributing the cash to Chillco as a beneficiary of the trust.[96] Corporate ownership of the insurance also has the future benefit of post mortem planning advantages and a potential reduction in the taxes arising on death.[97]

Considerations in determining the beneficiary of the policy include deciding where the insurance will be needed[98] and the potential reasons to separate the owner and the beneficiary. For the Freezes, whether the insurance is being used to fund the taxes or for estate equalization purposes (or both), the beneficiary should be Freezeco.

An issue that is sometimes overlooked with corporate-owned life insurance is that the capital dividend account credit is equal to the life insurance proceeds received by the corporate beneficiary less any applicable adjusted cost basis

(ACB) of the policy.[99] The ACB is defined in subsection 148(9) and is a calculation that is normally completed by the particular insurance company. Although advisers usually only have to make a request of the insurance company to obtain the ACB (and do not have to be concerned about completing the detailed calculation), it is useful to know the following:

- The ACB of a life insurance policy will eventually be reduced to nil (it cannot be a negative number) as the insured approaches the end of his or her life expectancy.
- In the early years of most policies, there can be significant ACB. Generally speaking, ACB peaks in years 10 through 12 and then starts to decline. Many policies will no longer have an ACB after about year 20.
- The amount of ACB will depend on the frequency and type of premium payments—for example, for a $4 million term-to-100 level cost of insurance policy for a husband and wife in their mid-60s, ACB could peak in year 12 at approximately $106,000, and would eventually decrease to nil by year 21.[100]
- The ACB will be attributable only to the owner of the policy. The CRA has outlined its concerns when there is a separation of owner and beneficiary, and it has commented that unless there is a non-tax reason for such a separation, it could use the general anti-avoidance rule to have the ACB of the policy reduce the amount of the capital dividend account.[101]
- It should be noted that not all of the CRA interpretations directly address the separation of owner and beneficiary. Some examine the issue of an entity other than the owner of the policy funding or paying the insurance premiums. It appears that the CRA is raising various provisions in the Act—such as section 9, subsections 15(1) and 245(2), and paragraph 12(1)(x)—when dealing with the payment of premiums to discourage the separation of owner and beneficiary.

If Victor and Nora are comfortable with separating the owner of the insurance and the beneficiary, given their relatively simple corporate structures, the insurance can be owned by Chillco, with Freezeco as the beneficiary. As reviewed earlier, the premiums for the insurance can then be funded by dividends paid by Freezeco to the trust on its common shares, with the cash being distributed by the trust to Chillco.

A number of other issues arise when insurance is used as part of the planning for a family business, some of which are as follows:

- *Policy dispositions*. The Act provides specific rules pertaining to policy dispositions, including the deeming of proceeds in non-arm's-length situations (which will often be the case if a policy is being transferred in a family business situation). "Disposition" is defined in subsection 148(9) and includes surrenders of a policy, partial withdrawals, and transfers of ownership, but specifically does not include the receipt of a death benefit. Pursuant to subsection 148(1), any proceeds received in respect of the transfer in excess of the ACB will be fully included in income, since life insurance is not considered to be capital property. Subsection 148(7) can deem the proceeds to be equal to the cash surrender value of the policy that is being disposed of in certain circumstances—for example, when the disposition is a non-arm's-length transaction or distributed from a corporation. However, care must be taken if there is a transfer of a policy from a corporation to an employee or a shareholder. Although the deemed proceeds will be the cash surrender value of the policy (which may be nil in many situations), the recipient of the policy must consider the fair market value of the policy when determining any shareholder or employment benefit.[102]

- *No section 85 rollover*. Life insurance is not included in the definition of "eligible property" for the purposes of section 85 transfers,[103] which can cause problems if the cash surrender value of the policy is greater than its ACB or if the fair market value of the policy is greater than its cash surrender value (potentially resulting in section 15 issues if the policy is being transferred to a shareholder—for example, as part of a butterfly-type transaction).
- *First-to-die insurance on Victor and Nora*. Although the insurance used for the parents will generally be on both lives (on the basis that there will be a spousal rollover for the assets owned by the first spouse to die, with the liquidity for the tax bill and any other funding requirements therefore not required until the second death),[104] there may be reasons to have first-to-die insurance. For example, if the family's decision is that Ice should manage the business within a defined period or after the death of Victor, it may be appropriate for the preferred shares to be repurchased after Victor's death (to provide Nora with liquidity and to relieve the business of the preferred share obligation). In addition, first-to-die insurance may also be appropriate for Victor as key person insurance—that is, to provide the business with liquidity as a means to alleviate the financial instability that his death might cause. Key person insurance may not have to be permanent insurance and may be in place only for the period that Victor expects to be active in the business.

Post Mortem Planning Opportunities

It is beyond the scope of this paper to review all the post mortem planning opportunities that will be available after the deaths of Victor and Nora and to review the stop-loss rules and the available grandfathering.[105] However, it is important to consider the circumstances in which grandfathering may be available in the Freeze family situation and some post mortem planning that could be implemented.[106] Assuming that the insurance on Victor and Nora is joint second-to-die, consider the following possibilities.

Branch A Grandfathering

This type of grandfathering is available primarily by virtue of a shareholders' agreement in place as at April 26, 1995 requiring (or at least allowing for) the corporate repurchase of shares owned at that date.[107] If the Freeze family has owned 100 percent of the shares from the date of inception of the business, then it is unlikely that a shareholders' agreement was in place as at April 26, 1995. Although the use of a family shareholders' agreement is discussed below under the heading "Shareholders' Agreements: Considerations in Mitigating Succession Challenges," generally these agreements have not been commonplace and the use of one would have been an exception back in 1995.

However, what if the Freezes had previously owned the company with one or more arm's-length shareholders? Was there a shareholders' agreement in place on April 26, 1995? If there was, has this agreement been modified in any way subsequent to April 26, 1995, or was a secondary agreement put in place after April 26, 1995?[108] Do the Freezes own the same shares as they did on April 26, 1995? This is unlikely because of the estate freeze transaction—the substitute share rule that is part of the grandfathering rules does not apply to branch A.[109]

Note that this grandfathering branch does not include any requirement that insurance has been in place on April 26, 1995. Therefore, if grandfathering is available under branch A, corporate-owned insurance could be purchased at any time subsequent to April 26, 1995.

Branch B Grandfathering

This type of grandfathering, which is mutually exclusive from branch A, has a number of requirements (which will not be reviewed in detail in this paper),[110] including the requirement that corporate-owned insurance has been in place on April 26, 1995. If there was such insurance, can it be shown that a "main purpose" of the insurance was for a corporate repurchase of the shares? Documentation issues must be addressed to show that the purpose test has been satisfied.[111] Note, however, that the insurance that was in place on April 26, 1995 does not have to stay in place—it can be replaced and additional insurance can be purchased after April 26, 1995 to supplement the existing amount.

The substituted share rule noted above applies for the purposes of branch B for section 51, 85, 86, and 87 transactions. Therefore, even though the Freezes have exchanged their common shares (which presumably are the shares that were owned on April 26, 1995) for preferred shares, the substituted share rule can still allow for grandfathering to apply if the requirements of branch B have been satisfied.

No Grandfathering

If grandfathering is not available under branch A or branch B, then the use of corporate-owned life insurance on a post mortem basis will not eliminate the taxes on the Freezes' preferred shares; however, it can still result in a significant reduction in taxes.

To illustrate, assume that Victor and Nora have not completed a wasting freeze and that they expect that the full amount of their $4 million of preferred shares will be owned on the death of the second to die. Also assume that $4 million of corporate-owned insurance is in place, which will result in a $4 million credit to Freezeco's capital dividend account (any ACB issues have therefore been ignored).

If there was no corporate-owned insurance, the tax bill on the second to die of Victor and Nora will be $874,000.[112] With corporate-owned insurance, the post mortem opportunities to be considered (ignoring for now the capital gains exemption) are the "50 percent solution" and what is often referred to as the "100 percent solution."[113]

The 50 percent solution will result in the stop-loss rules not applying because the post mortem transactions fit into the stop-loss exception,[114] meaning that the capital gain on death will be eliminated by a subsection 164(6) capital loss carry-back. The estate will have received $4 million of dividends, 50 percent of which will be non-taxable capital dividends and 50 percent of which will be taxable.[115] The taxes—if the taxable dividends are non-eligible dividends (and all are taxed at the highest marginal rate in British Columbia)—will be approximately $675,000. If the dividends are eligible dividends, the taxes will be approximately $522,000.

For the 50 percent solution, there will be $2 million remaining in the capital dividend account, which will result in future tax savings, and the family will have to consider at least two important questions: who should be the recipients of the remaining capital dividend account, and should some or all of the remaining capital dividend account be used as part of any estate equalization? Victor and Nora should be dealing with these questions now, and potentially addressing them as part of the family shareholders' agreement.[116]

For the 100 percent solution, all of the $4 million capital dividend account will be used for the post mortem planning, causing the stop-loss rules to apply. Half of the subsection 164(6) capital loss will therefore be denied, and the terminal return of the second to die of Victor and Nora will be taxed on $2 million of capital gains (50 percent of which will be subject to tax). The approximate tax will be $440,000. The estate will have no tax to pay, since the $4 million received on the share repurchase after death will be non-taxable capital dividends. Under the 100 percent solution, there will be no remaining capital dividend account.

To summarize:

- If there is no insurance, taxes will be $880,000.
- Under the 50 percent solution if the taxable dividends are non-eligible dividends, taxes will be $675,000 and $2 million will remain in the capital dividend account.
- Under the 50 percent solution, if the taxable dividends are eligible dividends, taxes will be $522,000 and $2 million will remain in the capital dividend account.

- Under the 100 percent solution, taxes will be $440,000, and there will be no remaining capital dividend account.

QSBC Shares: The Capital Gains Exemption

What if the QSBC capital gains exemption is available or has already been used so that there is a significant adjusted cost base in the shares owned on death? Assume that both Victor and Nora are able to use the full amount of the exemption, and that the shares owned on death have a fair market value of $4 million and an adjusted cost base of $1.5 million. The post mortem planning with $4 million of corporate-owned life insurance (again, assume a full credit of $4 million to the capital dividend account) can be accomplished as follows:

- Use $1.5 million of the capital dividend account to distribute to Ice, who will use the proceeds to purchase $1.5 million of shares. Prior to this cross-purchase, a reorganization of capital may have to take place so that the $1.5 million of adjusted cost base can be isolated in a separate class of shares. The remaining $2.5 million of shares will have a nil or nominal adjusted cost base.
- Implement the 50 percent or 100 percent solution for the remaining $2.5 million of value, resulting in either $1.25 million of dividends taxed in the estate or $1.25 million of capital gains taxed in the terminal return of the second to die of Victor and Nora. Because tax rates and tax laws can and will change over time, it is essential that the Freeze family not lock itself into one post mortem plan. The flexibility to deal with any changes can be provided for in the family shareholders' agreement, the will, or other documents.

Dealing with the Wasting Freeze

As described earlier, Victor and Nora may want to implement a wasting freeze (with some or all of the preferred shares repurchased during their lifetimes), so that the value of the preferred shares, and the corresponding capital gain, on the death of the second to die is considerably less than the original freeze amount of $4 million. However, one should not implement a wasting freeze just to have a reduced tax bill on death (since the family would then be essentially prepaying tax during the lifetimes of Victor and Nora) unless one or more of the following conditions are present:

- Victor and Nora need cash for personal purposes and need to access that cash from the company. Rather than have dividends paid to them on the preferred shares (or have dividends paid on the common shares and distributed to them via the trust), the cash can be provided by way of a redemption of some of the preferred shares.
- Freezeco or Chillco has accumulated a balance in its RDTOH account. A portion of the preferred shares can be repurchased, with the company

receiving a dividend refund. The taxes paid by Victor or Nora will approximate (if taxed at the high rate for a non-eligible dividend) the dividend refund received by the company. For example, if Freezeco has accumulated $100,000 in its RDTOH account, $300,000 of preferred shares can be repurchased, with the company receiving a $100,000 dividend refund and Victor and/or Nora paying tax of approximately $101,000 (if the dividends are ineligible dividends and are taxed at the highest marginal rate in British Columbia; taxes on eligible dividends at the highest marginal rate in British Columbia will be approximately $78,000).

- Freezeco or Chillco has accumulated a balance in its capital dividend account (for example, as a result of realizing a capital gain from disposing of some marketable securities). Victor and/or Nora can have some of their preferred shares repurchased at no tax cost, provided that the appropriate capital dividend account election and documentation was prepared and filed on a timely basis.[117]

If a wasting freeze is implemented, the following steps should be considered:

- Using multiple term insurance policies (and a permanent policy for the expected amount of shares remaining at death) to match with the decline in preferred shares. Tailor one or more policies using a "yearly renewable term" (YRT) so that the death benefit amount reduces over time. Although this option could match the declining preferred share amount better than the first option, it can result in higher premiums over the terms of the policies.
- Combine a YRT policy with leveraging to have a reduced amount of net death benefit but also to have a greater amount in the capital dividend account. The details of this option are beyond the scope of the paper, but it could be considered if a family requires the life insurance and is comfortable with overfunding the policy and using the cash values in the policy as security for a loan (with, ideally, the loan proceeds used for investment and/or business purposes so that the interest expense is deductible for income tax purposes).
- Continue with the original amount of insurance ($4 million in the post mortem planning examples above); use any "extra" insurance for estate equalization or other planning purposes.

Shareholders' Agreements: Considerations in Mitigating Succession Challenges

The Need for a Family Shareholders' Agreement

Shareholders' agreements are commonplace in closely held corporations where the shareholders deal at arm's length—that is, in non-family businesses. In these circumstances, shareholders seem to readily understand the benefits of having an agreement that deals with a wide range of issues, including governance, financing, non-competition, and the critical questions of when, how, and to whom shares may be transferred.

Shareholders' agreements are seen less frequently in family businesses, perhaps because families feel that they do not need legally binding documents to govern their business affairs. This sentiment may be especially prevalent in businesses involving parents and children, such as Freezeco in our example. Parents may feel, often with justification, that they do not need an agreement to enforce their ability to run the business day to day. By the same token, children may be prepared to defer to the parents, at least to a certain point, in recognition of their role in building the business and providing for the financial well-being of the family.

It is undoubtedly true that the dynamics of many families permit their businesses to be run successfully on a day-to-day basis. Other family businesses may require more legal structure, or at least the safety net of a shareholders' agreement, to facilitate corporate governance and proper management of the business. However, all businesses run by two or more family members (with the possible exception of those involving just two spouses) should have an agreement dealing with unexpected events such as death, disability, bankruptcy, and family breakdown. Similarly, family shareholders should have an agreement dealing with potential third-party purchases, and perhaps with methods of resolving shareholder disputes. A main objective should be the management of relations between sibling shareholders after the parents' deaths.

In the next section of this paper, we consider the types of provisions that might be included in family shareholders' agreements.

Issues To Be Addressed in Family Shareholders' Agreements

The terms of shareholders' agreements will vary with the circumstances of each situation and should be designed to meet the unique needs of the family in question. There are many issues that should be considered in each case, although they may not be addressed in the same way, or even included, in every agreement. In our example, the Freeze family should consider the following matters when deciding on the appropriate terms for their shareholders' agreement.

Governance and Management

Voting and Election of Directors

Parents undertaking an estate freeze typically want to retain voting control of the corporation as long as they have equity invested in the corporation. In our example, Victor and Nora have control through their class A shares of Freezeco.

It is possible for the shareholders' agreement to require that the shareholders vote their shares in a certain way, especially with respect to the election of directors, and especially when children own voting shares directly. For example, the agreement could provide for a board consisting of three directors and could require the shareholders to vote their shares so that Victor, Nora, and Ice (as long as he remains active) are elected. The agreement should also contemplate how to replace Victor or Nora on the board during any periods of incapacity or upon their deaths.

In some cases, it is advisable to have at least one non-family member act as a director, which can sometimes provide an independent perspective on the running of the business. This can be provided for in a family shareholders' agreement.

As in the case of arm's-length agreements, a family shareholders' agreement might stipulate circumstances that require unanimous shareholder approval (or perhaps 75 percent approval) rather than a simple directors' vote. These circumstances might include any one or more of the following:

- the issuance of new shares to any person outside a defined group;
- the redemption or purchase for cancellation of shares outside the terms already provided in the agreement;
- an increase or decrease in the number of directors;
- providing for one or more new classes of shares or otherwise amending the articles of the corporation;
- a winding up, dissolution, or amalgamation of the corporation;
- a material change in the business of the corporation;
- the renewal of corporate contracts;
- the sale or leasing of all or substantially all of the corporation's business assets to a third party;
- the borrowing of money by the corporation, or the pledging of corporate assets, in excess of a defined limit;
- providing financial assistance, including a guarantee, to any shareholder, director, employee, or related party; and
- the purchase of a capital asset in excess of a stipulated dollar limit.

The agreement might also contemplate succession on the board of directors—for example, how to replace a director who has died or become disabled. This is especially important in the context of an estate freeze, where one or both parents could conceivably remain on the board well into their 70s or 80s.

As noted, these issues are of greater importance when the freezors' children are shareholders of the corporation. In our example, at the time of the freeze Victor and Nora are the only individual shareholders, and they also form the majority of the trustees of the family trust that owns the participating shares of Freezeco. As such, they retain virtually unfettered control over the corporation. However, assuming that the business remains in the family and that shares are ultimately distributed from the trust to one or more of their children, voting and governance issues take on greater importance.

In this light, the timing of the agreement should be considered. On the one hand, it might seem unnecessary to implement the agreement at the time of the freeze, since Victor and Nora are in essence the only shareholders and it is possible that none of their children will become direct shareholders of Freezeco. On the other hand, there may be significant advantages in executing an agreement at the time of the freeze in contemplation of one or more of the children becoming shareholders in the future. This issue is addressed more fully below under the heading "Timing Considerations."

Family Council or Advisory Board

In some family businesses, a separate council or advisory board can be established to help guide business operations and establish family business succession policies. The mandate of these bodies is as provided in the shareholders' agreement. An advisory board will not usurp any powers of the directors, but—depending on its composition—it could be influential and be able to make recommendations to the board on a variety of issues.

Ideally, an advisory board is made up of senior family representatives who are or have been active in the business. However, younger up-and-coming family members who are active in the business can also be involved, as can trusted third parties from outside the family who can provide independent counsel. In fact, non-family members may, for liability reasons, prefer to be on an advisory board rather than on the board of directors.

In the case of the Freeze family, given the relatively small size of the corporation and the fact that the family is in the very early stages of a transition to the second generation, the establishment of an advisory board is likely premature. However, it could be considered if the business continues to grow and if family participation extends to a third generation.

Corporate Cash Flow and Distribution of Profits

The utilization of cash flow and the distribution of profits may assume particular importance in a family-owned corporation. The business may be financially supporting many family members, including the older generation whose participation in the business may be diminishing but who still rely on corporate profitability to sustain their lifestyle. In that case, it may be incumbent on the shareholders to establish rules in their agreement for the prioritization of cash flows. For example, they might provide that cash flow be devoted

- first to cover the needs of the parents;
- second to cover operational needs, including reasonable compensation to family members; and
- finally to cover cash flow needs of the family trust or of other family shareholders who may not be active in the business.

Cash flow priorities should also be taken into account in determining policies concerning the payment of dividends, and perhaps the timing of the redemption of shares owned by the parents, all of which can be included in the shareholders' agreement. Ideally, the agreement will provide a balance between the active children's desire to manage corporate cash flows and the parents' need for income. If a wasting freeze is utilized, as discussed earlier in the paper, the agreement should clearly indicate the rules governing the number of shares that the parents are permitted to redeem within a given time.

Different perspectives will also exist among active children such as Ice, whose main focus is sustaining the business, and non-active children such as Drip, who is mostly concerned about day-to-day living expenses. In this regard, of course, the preferred route is to keep children such as Drip from becoming shareholders at all, whether voting or non-voting. This point is of particular concern when shares owned by the children are retractable—that is, when the shareholders can require the corporation to redeem the shares. This is not usually a concern when the parents own the retractable shares, but it can become a serious issue when the shares are owned by children, particularly non-active children.

As discussed, the agreement may contain restrictions on when shareholders can require a redemption of shares. It is possible that a shareholding child may take the position that an agreement cannot restrict a shareholder's retraction right; however, the safer route in most cases is to include the provision rather than make it too easy for the children to demand cash in exchange for their shares. Such a restriction should not be included until the family and its advisers consider the impact on the valuation of the shares, particularly if the restriction existed in the agreement while the holders of the preferred shares were still alive.

Shareholder Loans

The agreement might contain rules regarding shareholder loans. For example, will loans from shareholders bear interest? Will they be tax-free? Should the agreement contain terms regulating the timing and manner of shareholder loan repayments? The agreement might also contemplate the need to obtain financing from the shareholders and the implications for any shareholder who is unable to provide it.

Employment and Remuneration Policy

A family shareholders' agreement should outline the expectations for non-arm's-length employees of the business. This should be done even in cases where children such as Ice are employees of the business but not yet shareholders (except perhaps indirectly via a family trust). For example, the agreement might stipulate that family members will be compensated in a way that reflects the fair market value of their services. This compensation would include salary, benefits, and vacation entitlement. Job descriptions should be clearly set out. Arm's-length, objective benchmarks should be used wherever possible. This can be particularly important if there are key employees who are not family members and who could become resentful if a child of the business owner receives preferential treatment. The agreement could also codify arm's-length standards for hiring, promotion, and dismissal.

Rules Regarding the Transfer of Shares

As in any shareholders' agreement, a focal point of a family shareholders' agreement should be the terms and conditions under which shares may or must be transferred. However, the unique nature of family business may necessitate a different approach to many common provisions.

Right of First Refusal

Most shareholders' agreements will provide for a right of first refusal—that is, no shareholder may sell his or her shares to a third party without first offering them on the same terms to the other shareholders. In most cases involving family businesses, this clause will have limited impact because the third party will be unlikely to want the prospective seller's shares if the others are remaining as shareholders. Even when it is theoretically possible for such a clause to be invoked, it may be unfair to non-selling shareholders who do not have the financial ability to purchase the shares. Such a clause at least raises the possibility of the non-selling shareholders being forced into a new business relationship with a third-party stranger.

Tag-Along and Drag-Along Rights

A tag-along provision allows a shareholder to piggyback on the sale of another shareholder's shares to a third party. If the provision is invoked, the former shareholder will be able to sell his or her shares to the purchaser on the same terms. A drag-along provision allows the selling shareholder to require the other shareholders to sell. These provisions can be coupled with a right of first refusal that gives the non-selling shareholders the first opportunity to purchase.

Tag-along and drag-along rights may or may not be suitable mechanisms in a family business setting, especially when they could easily lead to the business being sold outside the family despite the wishes of many family members.

Shotgun Arrangements

Under a shotgun arrangement, one shareholder (the initiator) can start a process that forces the other shareholder to either purchase the initiator's shares or sell his or her shares to the initiator. The price is established by the initiator and, in theory, is not too low (which would encourage the other shareholder to buy) or too high (which would encourage the other shareholder to sell). In other words, the price should be one that suits the initiator whether he or she is buying or selling.

A shotgun arrangement is an ideal method of breaking a shareholder deadlock when the parties are equal in shareholdings, bargaining position, and financial strength. When there is an inequality, a shotgun arrangement may be perceived as unfair to the weaker party. This perceived unfairness can be magnified when family is involved, especially family members of different generations. For this reason, shotgun arrangements in a family business should generally be avoided, although this does admittedly make shareholder deadlock more likely.

Permitted Transfers

The agreement might provide that certain transfers of shares by family members will be permitted without the approval of other shareholders. These might include the transfer to a holding company controlled by the transferor, or a transfer by the parents to children or other family members specifically identified in the agreement. Otherwise, no transfers should be permitted without the approval of other shareholders. Often, families will want provisions included in the shareholders' agreement to restrict the possibility of shares being transferred outside family bloodlines without the unanimous consent of other shareholders. Such provisions can be particularly challenging if one wants to provide income to a surviving spouse while ensuring that shares ultimately transfer along bloodlines. Including the possibility of a transfer to a qualifying spouse trust in the shareholders' agreement can assist in addressing this issue.

Special rules may be included to govern the transfer of voting shares (the class A shares in the case of the Freeze family). In situations where consideration is given to having non-active children as shareholders, it may be necessary that the agreement include rules limiting or preventing the transfer of voting shares to the non-active children. Depending on the family involved, it may be desirable that voting shares be held only by the parents and the active children (and not by any spouses of the children). No one should be entitled to become a shareholder without signing the shareholders' agreement.

Events Triggering a Purchase and Sale of Shares

Most shareholders' agreements contain triggering events that create rights and obligations concerning the purchase and sale of shares. The following are common examples:

- *Death*. The death of a shareholder may trigger the mandatory purchase and sale of the deceased's shares, or perhaps put and call options involving the estate, the survivors, and the corporation, when a family does not want the shares to transfer to successive generations.[118] The death of one or both parents may or may not trigger buy-sell obligations (in many cases, shares are simply gifted to the next generation). There may also be different terms and conditions attaching to the voting non-participating shares on the one hand and to non-voting participating shares on the other. As discussed earlier, there are many unique strategies for the use of life insurance in these situations.

- *Disability*. The family shareholders' agreement should contemplate the purchase and sale of shares on a shareholder's disability, although only within certain parameters. For example, the disability of an elderly parent should not trigger a purchase and sale of shares. However, a buyout can be provided for upon the disability of a child who is active in the business, unless there is an overriding philosophy that the shares are to be transferred along bloodlines. The most obvious potential buyers are the child's siblings or other family contemporaries, but likely not the parents. The buyout can be optional on the part of the non-disabled parties, thus enabling them to assess whether or not the purchase is affordable. Disability buyout insurance can be considered as a funding vehicle.
- *Bankruptcy and insolvency*. As in an arm's-length setting, it is in the interests of the other shareholders to be able to purchase shares owned by a shareholder who is bankrupt or insolvent. Normally, the buyout will be optional on the part of prospective purchasers. A discounted purchase price—say, 50 or 75 percent of the price otherwise calculated—is sometimes applied in these circumstances.
- *Marriage breakdown*. This is a particularly sensitive topic in family businesses, but it can affect businesses of all kinds. In some cases, it is possible for shares to be used to satisfy matrimonial claims, which can have obvious repercussions for family relationships and smooth business operations. The other shareholders can be given buy-sell rights in these circumstances, although it is questionable whether such rights will be enforceable against a recipient spouse who was not a party to the shareholders' agreement. If possible, shareholders can protect themselves by entering into matrimonial contracts that prevent shares from being used in satisfaction of spousal rights. In certain cases, it may be possible to require that such a contract be executed as a condition of becoming a shareholder.
- *Termination for cause*. Assuming that the corporation intends to enforce arm's-length employment standards, as described above, it may be appropriate to provide for the sale of shares held by an employee-shareholder who is dismissed for cause. This provision may not apply in cases where shares are to remain within bloodlines in any event. A discounted purchase price can be provided for in the agreement.
- *Breach of agreement*. Similarly, where a party breaches the agreement, the sale of his or her shares at a discounted purchase price can be provided for.

Valuation

Valuation is a critical component of any shareholders' agreement, but perhaps especially in the case of agreements among family members. The CRA has a clear policy indicating that paragraph 69(1)(b) may apply when shares are bought and sold between parties not dealing at arm's length. In that case, the deemed proceeds of disposition will equal the shares' fair market value, notwithstanding the purchase price determined under the agreement. The CRA's policy is set out in *Interpretation Bulletin* IT-140R3:

> 2. When determining the proceeds deemed to have been received by the deceased pursuant to subsection 70(5), the fair market value of the property subject to the buy-sell agreement must be determined at the time immediately before death. The Department's view is that, where the deceased and the surviving party to the buy-sell agreement (survivor) did not deal at arm's length, it is a question of fact whether the fair market value for the purpose of subsection 70(5) will be determined with reference to the buy-sell agreement.
>
> 3. Where the deceased and a survivor did not deal at arm's length at the time the agreement was made, the Department's view is that paragraph 69(1)(b) applies when the estate sells the property to the survivor pursuant to the agreement and that it is a question of fact whether fair market value under paragraph 69(1)(b) will be determined with reference to the buy-sell agreement.[119]

The shareholders' agreement should stipulate that when the triggering event for a purchase and sale of shares is death or disability, the purchase price is the shares' fair market value, which is to be determined regularly by a qualified independent business valuator and thoroughly documented. This is the best method of ensuring that the purchase price will withstand CRA scrutiny. Formulas for determining fair market value can be used, but should be reviewed regularly to ensure that they are still applicable. This point is of particular importance in the case of family businesses, where share transfers generally take place between non-arm's-length parties. An out-of-date formula that results in a price that is below fair market value, for example, could result in the application of paragraph 69(1)(b) as described above.

As indicated above, the purchase price may be discounted on the happening of certain events such as bankruptcy, termination for cause, or a breach of the agreement. This provision should be supportable in a family-owned business setting as long as the parties can demonstrate that clauses such as this are frequently found in arm's-length shareholders' agreements.

Given the concern that the CRA may challenge share values determined under a non-arm's-length agreement, the parties might consider the inclusion of a price adjustment clause. This provision allows the purchase price to be adjusted up or down upon a final determination that the original price did not reflect fair market value. The very existence of such a clause should motivate the parties to utilize the best available methods to determine fair market value, since an after-the-fact adjustment could have serious repercussions for a purchaser who may need to obtain more capital for the buyout or, conversely, for a vendor who must repay some of the sale proceeds.

The following are some additional considerations regarding valuation:

- In a family business setting, it is generally not appropriate to apply a minority discount to an individual's shares. In most cases, the overall value is attributable to the family group as a whole rather than to a specific majority shareholder. A minority discount may be more applicable in certain arm's-length situations.
- The value and tax cost of corporate assets may be considered in valuing the shares of the corporation. In certain cases, a discount may be appropriate to take into account the tax cost of selling corporate assets. The presumed immediacy of an asset sale will be a significant factor in determining whether such a discount should apply.
- In the case of the purchase and sale of shares on death, the appropriate price is typically the fair market value of the shares immediately before death. This represents the deemed proceeds of disposition under subsection 70(5). The perceived imminence of death should not be a consideration in determining fair market value, nor should the amount of any insurance proceeds receivable by the corporation on the shareholder's death. (The cash surrender value of any policies on the deceased's life should be included, as provided in subsection 70(5.3).) Once again, non-arm's-length parties in these circumstances may be required to demonstrate that provisions of this nature are commonplace in arm's-length agreements and that they represent appropriate valuation principles.

Non-Competition, Non-Solicitation, and Confidentiality

The considerations with respect to these types of provisions are the same as they are in arm's-length agreements. When a shareholder ceases to be a shareholder-employee of the corporation, a non-competition clause can prevent him or her from competing with the business for a given time within a given geographical area. Similarly, the individual can be prevented from soliciting clients of the business and from disclosing confidential information relating to the business.

Dispute Resolution

In some cases, buy-sell provisions such as tag-along and drag-along rights or shotgun arrangements can be used as an ultimate means of resolving disputes. Although they are imperfect, these mechanisms at least provide an opportunity for unhappy shareholders to sell their shares to each other or to a third party, thereby severing the business relationship. As a practical matter, however, there is no certainty that these potential remedies will be of benefit. For example, there may not be a third party who is interested in purchasing shares of the corporation where he or she would be in a minority position relative to family ownership, and who could begin a process that concluded with shareholders exercising tag-along or drag-along rights. Or the parties' financial position may be such that a shotgun buy-sell arrangement is not affordable for any of the shareholders.

Family dynamics being what they are, shareholder disputes in a family business can create great acrimony. In addition, remedies that lead to the potential sale of shares to a third party outside the family may be an undesirable development in a family business. Another approach is to have the shareholders' agreement provide for arbitration to resolve disputes. There is no certainty that arbitration will lead to a result that pleases all parties, but it may allow contentious matters to be settled before they reach a critical stage. In the hands of the right arbitrator, negotiation and mediation among the parties might also be encouraged. An independent director can have a significant role to play in resolving disputes once the parents are no longer on the scene.

Timing Considerations

As suggested above, a family shareholders' agreement is normally seen as a tool to be used when children become shareholders. In the case of the Freeze family, as with many families undertaking an estate freeze, a trust controlled by one or both parents may own the common shares for a considerable number of years. In effect, the parents own all the shares, and they may question why a shareholders' agreement is needed at that stage. Why not wait until the trust distributes shares to the children/beneficiaries at some future date?

In answering this question, the adviser should urge the parents and other family members to consider the potential impact of the passage of time on the personal circumstances and bargaining position of the parties. In the case of the Freeze family, their children are aged 35 to 40 and, for better or worse, the paths of their lives are becoming apparent. In other cases, the beneficiaries of the freeze may be a decade younger or more, and their futures may be less clear. Whatever the circumstances of the beneficiaries at the time of the freeze, they can change dramatically over the years prior to the distribution of shares from the trust. The following is a non-exhaustive list of potential issues that could affect the children in the years following a freeze:

- They could marry or become divorced.
- They could enter into matrimonial and/or separation agreements.
- They could become bankrupt or incur other financial problems.
- One or more of them could become non-resident.
- One or more of them could develop health or addiction problems.
- Personal relationships between them could worsen or improve.
- They could make significantly different contributions to the business over the years and develop expectations regarding an entitlement to shares that is disproportionate to those contributions.

Any one or more of these issues could have a dramatic impact on family dynamics and on the business itself, and could undermine any attempt to negotiate a family shareholders' agreement successfully. What if one of the children is disappointed in the number of shares he or she receives from the trust? Or what if a child who is deserving of shares is involved in a difficult matrimonial situation?

One possible solution to these concerns is to have a shareholders' agreement signed at the time of the freeze by any freeze beneficiaries who are of legal age and capacity. Younger beneficiaries would sign the agreement as they reached the age of majority. The agreement would be executed in contemplation of receiving a share distribution from the trust at some future date. Ideally, the agreement would be done before the issues described above changed the lives of the children and complicated the negotiation process. The ground rules would be established from the beginning. Ideally, the agreement would be negotiated at a time when the parents were still capable and able to influence their children in a way that allowed the agreement to fulfill appropriate business succession objectives. Independent legal advice is highly recommended as a way of ensuring that the children, in particular, fully understand their respective rights and obligations.[120]

The reality, of course, is that there is no perfect solution. The best possible legal document executed at the most opportune time will not overcome the personal upheavals that can sometimes arise within families. However, an agreement that is executed before emotions run high can be a crucial tool in family business succession. While the existence of an agreement will not guarantee an untroubled succession, the absence of one will almost certainly make succession more difficult.

Notes

1 For the purposes of this paper, a "family business" is assumed to be an active business where more than one family member is involved in the ownership and/or management of the business. It should be noted, however, that many of the succession challenges identified in this paper apply equally to the transition of corporately owned passive wealth within a family.

2 It is estimated that 60 to 70 percent of family businesses will not survive into the second generation and 85 to 90 percent will not survive into the third. See Manfred F.R. Kets De Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News" (1993) 21:3 *Organizational Dynamics* 59-71, and Laura Koss-Feder and Valerie Marchant, "Business, Too Close to Home," *Time* (July 17, 2000).

3 For example, Canadian Association of Family Enterprise (www.cafecanada.ca) and Family Firm Institute, Inc. (www.ffi.org).

4 The term "founder" is used to define the owner of the business prior to the estate freeze and, for the purposes of this paper, is considered to include the individual who controls the family business and his or her spouse.

5 The founder may also not want to incur the professional fees that can arise in effectively addressing these issues. In this regard, the upfront cost relative to the potential cost to the business if these issues are not effectively dealt with during the founder's lifetime needs to be considered.

6 A trained facilitator can be instrumental in helping the family work through issues that may be impeding family members' ability to communicate and make effective decisions with respect to the succession plan. A facilitator can help ensure that the family members' concerns regarding the succession plan are identified and discussed as part of the process of implementing the estate freeze.

7 Many founders will have heard about estate freezes. They may be anxious to move forward with this planning once the retirement decision is made because they have the sense that it is the ultimate succession- and estate-planning solution. However, due consideration must be given to the soft issues that relate to the succession plan before an estate freeze can be effectively implemented. Patience is often required on the founder's part, in terms of delaying the implementation of the estate freeze, to be sure that the soft issues have been adequately addressed.

8 Although it is often the case that a sale of the business might be the most effective option to promote long-term family harmony and stewardship of wealth.

9 Careful consideration needs to be given to the corporate attribution rules in subsection 74.4(2) of the Income Tax Act (RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"; unless otherwise stated, all statutory references in this paper are to the Act) if a spouse is going to be brought in as a shareholder or beneficiary of the trust through the estate freeze process. It may be possible to have the spouse become a beneficiary of the trust following the death of the founder in order to mitigate the implications of the corporate attribution rules during the lifetime of the founder.

10 This point is of particular significance in British Columbia and Nova Scotia, where a claimant under the Wills Variation Act (RSBC 1996, c. 490) or the Testators' Family Maintenance Act (RSNS 1989, c. 465) is not required to establish financial dependency.

11 For summaries of estate freeze techniques and related technical issues, see, for example, Charles P. Marquette, "Estate Freezes Involving Trusts," Personal Tax Planning feature (2002) 50:1 *Canadian Tax Journal* 335-59; Timothy G. Duholke, "Managing the Estate Freeze," in *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), 34:1-22; Timothy P. Kirby and Jon D. Gilbert, "Fundamentals of Estate Freezing," in *2009 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2009), 6:1-68; Martin J. Rochwerg and Krystle A. Ng-A-Mann, "Freezing, Thawing, and Refreezing: The Intricacies of an Estate Freeze," in *2009 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2009), 12:1-29; and Steven J. Kohn, "Tax Planning During the Life Cycle of a Business—Practical Tips and Traps," in *2001 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2001), 11:1-44.

12 See the publications cited in note 11 supra.

13 For instance, if a family trust is to be used as part of the estate freeze transaction, consideration must be given to the anticipated age of the beneficiaries at the time of the 21st anniversary of the trust, when assets might otherwise be distributed to the beneficiaries. Also, if the founder is not going to be a beneficiary of the trust, he or she needs to be comfortable that the value of any preferred share received through the estate freeze plus any other assets that he or she may own will be sufficient to provide for his or her retirement needs.

14 Careful consideration must be given to the person that will be settling the trust. As a general rule, in order to protect against the possible application of subsections 75(2) and 107(4.1) (which can create particular challenges with respect to 21st-anniversary planning for any trust) no one who will ever be a trustee or beneficiary of the trust should settle or otherwise contribute property to the trust. Furthermore, in order to protect against a possible argument by the CRA that the settlor is acting as agent for the founder in settling the trust (and the inherent issues with respect to subsection 75(2) that could arise from such an argument), none of the founder's advisers should settle the trust.

15 This type of provision is recommended to be included in the trust document in order to mitigate the risk that value will be attributed to a beneficiary's discretionary interest in the trust where the beneficiary is acting as sole trustee of the trust.

16 This provision is included in the trust document to avoid subsection 74.4(2) attribution concerns through the exception included in subsection 74.4(4). In this case, Nora and Victor are equal shareholders of the company at the time of the estate freeze, and therefore the corporate attribution rules should not apply in respect of a spouse.

17 Consideration must be given to the possible valuation risks associated with voting non-participating shares. The CRA has said that

> non-participating controlling shares have some value and may therefore bear a premium. However, in the context of an estate freeze of a Canadian-controlled private corporation, where the freezor, as part of the estate freeze, keeps controlling non-participating preference shares in order to protect his economic interest in the corporation, the CRA generally accepts not to take into account any premium that could be attributable to such shares for purposes of subsection 70(5) of the Income Tax Act at the freezor's death.

"Questions and CRA Responses," in 2009 British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 2009), 16:1-15, at 16:2. The CRA expanded on these remarks in "Canada Revenue Agency Round Table," in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 3:1-30, at 3:2:

> Provided that the owners of all the shares of the corporation act in a manner consistent with the assumption that no value attaches to the voting rights, and the rights are eventually extinguished for no consideration, the CRA will generally not attribute value to the rights. If the holder of the rights uses them to run the corporation in conflict with the common shareholders or seeks or is offered consideration for them, it would be difficult for the CRA to ignore this evidence of value.

18 Consideration could also be given to including a charity as a beneficiary of the trust in order to provide for the philanthropic objectives of the family.

19 This provision is recommended in order to mitigate the possible risk of subsection 75(2) being found to apply to the trust in certain situations where a corporate beneficiary is included in the trust.

20 This provision is recommended to protect against the possible application of subsection 75(2) if for any reason the settlor was found to be acting as agent for a trustee or beneficiary of the trust in settling the trust (in this case, particularly with respect to acting as agent for Victor or Nora). Consideration could also be given to including a clause in the trust document such that the initial trust property cannot be disposed of by the trust except in satisfaction of a liability of the trust.

21 It is recommended that borrowed funds be used to acquire the shares (that is, instead of the settled property) to protect against attribution and subsection 75(2) concerns that could otherwise arise in the event that the settlor was found to be acting as agent for Victor or Nora in settling the trust.

22 A separate class of voting non-participating shares is used to segregate the votes into a separate class of shares to allow for transition of votes of the company on a separate basis from the value or participating shares of the company. The shares are redeemable by the company and retractable by the holder for their par value per share to support a position for the value of the shares equaling the par value of the shares. The CRA's position with respect to the value of voting non-participating shares is discussed at other points in this paper.

23 For a comprehensive discussion of share attributes, including rights and restrictions required by the CRA in order to support fair market value of shares received in a tax-free exchange under section 85 or 86, see Charles P. Marquette, "Share Capital Attributes: Corporate and Tax Issues," Personal Tax Planning feature (2009) 57:3 *Canadian Tax Journal* 607-31. The CRA's policies in this regard were first announced in "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Second Tax Conference*, 1980 Conference Report (Toronto: Canadian Tax Foundation, 1981), 591-628, question 13, at 602. More recently, the CRA has explicitly reiterated these policies in CRA document no. 2008-0285241C6, October 10, 2008.

24 Generally, the inclusion of a price adjustment clause is intended to mitigate undesired tax consequences (for example, the unintentional conferring of a benefit on a new shareholder) that may arise where the value is challenged by the CRA. Valuation aside, the CRA has publicly subjected this retroactive adjustment itself to scrutiny and challenge, most recently in *St. Michael Trust Corp. v. Canada* (2010 FCA 309) (also known as *Garron Family Trust*). Therefore, these attributes must be very carefully crafted to ensure that the price adjustment clause is effective for the desired purpose. (See Joan E. Jung, "Price Adjustment Clauses Under Attack?" (2011) 11:2 *Tax for the Owner Manager* 1-3.) The CRA's longstanding administrative position with respect to price adjustment clauses is laid out in *Interpretation Bulletin* IT-169, "Price Adjustment Clauses" (August 6, 1974), including the general conditions under which the CRA states that it will recognize a price adjustment clause.

25 The attributes of the class C preferred shares of Chillco will be consistent with the CRA's stated position in order to support the fair market value of the shares, as discussed with respect to the attributes of the preferred shares of Freezeco.

26 This share redemption creates a tax-deferred intercorporate dividend to Chillco on the basis that Chillco and Freezeco will be connected, Freezeco has no refundable tax balance, and the provisions of subsection 55(2) and part VI.I do not apply to the intercorporate dividend.

27 Sufficient time must elapse after the exchange of shares and before the payment of the dividend to allow for retained earnings to increase by an amount at least equal to the amount of the dividend; otherwise, the dividend will cause the net assets of Freezeco to fall below the redemption value of the outstanding preferred shares and the company will be offside the terms of the preferred shares.

28 To qualify for a rollover at cost on death, the spouse trust must meet the conditions of subsection 73(1.01) such that the surviving spouse is entitled to receive all of the income of the trust and no one other than the surviving spouse is able to receive or otherwise obtain the use of any of the income or capital of the trust.

29 Although our analysis assumes that tax legislation and rates are the same as is currently the case in 2011.

30 Based on the top marginal tax rate on capital gains in British Columbia of 21.85 percent. It is assumed that the shares will not qualify for the capital gains exemption due to the passive investments held in Freezeco.

31 As noted previously, there is a risk that the CRA could ascribe value to the voting non-participating shares of Freezeco and Chillco. The share attributes have been structured to mitigate this risk; however, if this risk remains a concern, consideration can be given to having the voting shares of the companies owned through the trust. Various other considerations come into play prior to undertaking this step, particularly with respect to any post mortem planning that may be required following the death of the last to die of Victor and Nora.

32 In other words, the related taxes will become payable (subject to the capital gains exemptions of the beneficiaries of the trust) upon the sale or repurchase of the shares. If this tax deferral is one of the significant benefits that the founder is considering in pursuing an estate freeze, it is imperative to consider the intentions of the beneficiaries to determine whether the beneficiaries intend

to continue to hold their shares following the death of the founder. If the beneficiaries intend to sell their shares, this tax deferral will not be realized.

33 Double taxation can arise without proper planning when an individual dies owning shares of a private company with accrued gains inherent in the shares. This result can arise if the estate pays tax on the capital gain arising from the deemed disposition of the shares on death and the same amount of accrued gain is taxed again when the company sells the corporate assets and distributes them to the shareholders on windup without the resulting capital loss being available to offset capital gains to either the estate or the beneficiaries. These issues are discussed later in the paper.

34 Before consideration of any alternative minimum tax implications for the beneficiaries.

35 Assuming that the funds continue to be invested corporately in order to maintain the related tax deferral.

36 Using 2011 tax rates, and assuming that Slush's provincial jurisdiction is only British Columbia.

37 The degree of protection that is provided by a discretionary family trust with respect to marital and/or creditor claims of a beneficiary will vary from jurisdiction to jurisdiction, particularly insofar as it relates to claims on marital breakdown. See below under the heading "Family Relations Issues," for a discussion of the impact of the British Columbia Family Relations Act, RSBC 1996, c. 128.

38 In very general terms, the division of corporate assets into separate companies on a tax-deferred basis is simpler to achieve while the parents control the respective companies. This result can be very challenging and costly to achieve following the death of the founder when shares of the company are owned between siblings, due to subparagraph 55(5)(e)(i), which deems siblings not to be related.

39 It is generally recommended to provide at least five years (prior to the retirement of the founder) to allow for the necessary skills development of the successor and to communicate with and gain the confidence of stakeholders (including family members, employees, customers, suppliers, and bankers).

40 The extent to which probate fees are charged will vary by province. In British Columbia, for instance, probate fees are generally charged at a rate of $350 on the first $50,000 plus 1.4 percent of the value of assets in excess of that amount transferring through the will. Victor, who is 65, can transfer his property to an alter ego or joint partner trust on a tax-deferred basis; the assets in the trust will not be subject to probate fees. A full discussion of alter ego and joint partner trusts is beyond the scope of this paper.

41 These implications can be dramatic and will require consultation with a cross-border tax specialist. A review of these tax implications is beyond the scope of this paper.

42 These implications should be considered at the time the freeze is implemented so that the trust can be structured to allow for planning to mitigate them. This planning is not considered further in this paper.

43 These implications should be considered at the time the freeze is implemented so that the various options with respect to mitigating double tax exposure inherent in the shares following Victor or Nora's death can be mitigated. These planning considerations are discussed in more detail later in the paper.

44 For a general discussion of sections 74.1, 74.2, and 74.4 and subsection 75(2), see Ian Worland, "Constant and Current Issues in the Taxation of Domestic Trusts," in *2010 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2010), 4:1-54. Subsection 75(2) is discussed in detail in Brenda L. Crockett, "Subsection 75(2): The Spoiler," Personal Tax Planning feature (2005) 53:3 *Canadian Tax Journal* 806-30. More recently, subsection 75(2) was considered by the Tax Court of Canada in *Sommerer v. The Queen*, 2011 TCC 212 (aff'd. 2012

FCA 207) and *Garron Family Trust v. The Queen*, 2009 TCC 450 (although not in the appeals to the Federal Court of Appeal (*St. Michael Trust Corp*., supra note 25) and the Supreme Court of Canada (2012 SCC 14)).

45 The meaning of “revert” for this purpose has been the subject of much discussion, most recently in *Sommerer*, supra note 44.

46 Unless the trust has a majority rule provision and precludes the possibility that the contributor may be the only trustee or one of two trustees.

47 Again, unless the trust has a majority rule provision and precludes the possibility that the contributor may be the only trustee or one of two trustees.

48 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax and Sales and Excise Taxes* (Ottawa: Department of Finance, October 31, 2011), clause 18(3).

49 Paragraph 251.1(1)(a).

50 Paragraph 251.1(1)(b).

51 Paragraph 251.1(1)(c).

52 Paragraphs 251.1(1)(d)-(f).

53 Paragraph 251.1(4)(a).

54 Paragraph 251.1(4)(b).

55 Subsection 251.1(3).

56 That is, within the expanded meaning of that expression in subsection 248(25).

57 Subsection 251.1(3), “beneficiary.”

58 Subparagraph 251.1(4)(d)(i).

59 This is not an exhaustive review of the trust affiliation rules. For example, additional interpretive rules are set out in paragraphs 251.1(4)(c) and (d).

60 Although subsection 40(3.61) provides some relief from the application of this loss-denial rule in the case of a loss realized by an estate within the first taxation year of an estate, the exception does not apply to losses realized by inter vivos trusts, including alter ego and joint partner trusts.

61 The CRA has ruled that GAAR does not apply to this type of transaction: CRA document nos. 2001-0093363, 2001, and 2003-0018823, 2003.

62 See note 17 supra.

63 *MNR v. Consolidated Holding Co. Ltd*., [1972] CTC 18 (SCC).

64 CRA document no. 2004-0087761E5, May 24, 2005.

65 This analysis may not be as persuasive in view of the Tax Court’s judgment in *Lipson v. The Queen*, 2012 TCC 20.

66 The exemptions for QSBC shares, qualified farm property, and qualified fishing property are provided in section 110.6. They are actually deductions that can be claimed in computing taxable income for the purposes of the Act.

67 A spousal trust may be eligible to claim the capital gains exemption for the taxation year of the trust in which the spouse or common-law partner dies (subsection 110.6(12)). The provision is expressly stated to be unavailable to alter ego trusts and joint partner trusts. If a trust that is not eligible to claim an exemption by virtue of subsection 110.6(12) has realized a capital gain on the disposition of a qualifying property, the taxable capital gain can be sheltered only if it is deemed to have been realized by a beneficiary by virtue of designations made under subsections 104(21) and (21.2), as is discussed above. However, the subsections 104(21) and (21.2) designations cannot be made unless the taxable capital gain is included in the income of the beneficiary by virtue of subsections 104(13) and (14) or section 105. Because subparagraph 104(6)(b)(iii) precludes the possibility of such an inclusion in respect of gains resulting from

the deemed disposition under subsection 104(4), the designation cannot be made and the taxable capital gain is trapped in the trust. Thus, an alter ego trust cannot use the capital gains exemption available in respect of qualifying property to shelter gains resulting from the deemed disposition of the property in the trust on the settlor's death. Similarly, a joint partner trust cannot use the exemption to shelter capital gains resulting from the disposition of such assets on the death of the survivor of the settlor and the spouse or common-law partner.

68 CRA document no. 2012-0439271E5, June 4, 2012.

69 Except to the extent that Freezeco receives a dividend refund.

70 See question 13 of the 2007 APFF conference round table, reproduced in CRA document no. 2007-02432411C6, October 5, 2007. See also CRA document no. 2006-0218501E5, March 9, 2007.

71 Paragraph 108(1)(g), definition of "trust."

72 Subparagraph 108(1)(g)(iv), definition of "trust."

73 Income arising from a source outside Canada will be exempt from the withholding tax by virtue of article XXII(2) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

74 Internal Revenue Code of 1986, as amended.

75 See the discussion under the heading "Investment Holding Companies" above. Corporations (other than registered charities) and partnerships should not be included in the class of beneficiaries or potential beneficiaries if the trust will be used to hold a principal residence.

76 It should generally not be held by the settlor or any person who has contributed to the trust, since that would result in the application of subsection 75(2).

77 CRA document no. 2003-0181465, April 3, 2003.

78 [1964] AC 612 (HL). See also *Re Halsted's Will Trusts*, [1937] 2 All ER 570 (Ch. D.).

79 For example, under section 23 of the British Columbia Wills Act, RSBC 1996, c. 489, a general devise of property in a will operates to dispose of any property disposable by a general power of appointment.

80 [1983] STC 517; (1983), 57 TC 301 (CA).

81 [1943] AC 468 (HL).

82 [1963] 2 All ER 1030 (HL).

83 [1981] 1 All ER 736 (HL).

84 Supra note 78.

85 Supra note 37. Proposed legislation will completely overhaul the family law legislation in British Columbia and have the effect of protecting interests in certain trust property held at the commencement of a relationship from claims on a breakdown of the relationship.

86 Family Relations Act, supra note 37, section 58(2).

87 Ibid., section 58(3)(a)(ii).

88 Ibid., section 58(3)(b)(i).

89 Ibid., section 58(3)(b)(ii).

90 Ibid., section 68.

91 The rollover would be pursuant to subsection 70(6) of the Act.

92 The CDA credit, the adjusted cost basis of the policy, and the separation of the owner and beneficiary of the insurance policy are reviewed later in the paper.

93 The 50 percent solution will result in capital dividends equal to $874,000, taxable dividends equal to the same amount, and the so-called pipeline strategy being used for the balance of the value of the shares. It has been assumed that the pipeline strategy would be implemented so as to avoid any subsection 84(2) issues, as outlined by the CRA in "Canada Revenue Agency Round Table," in *Report of Proceedings of the Sixty-Second Tax Conference*, 2010 Conference Report (Toronto: Canadian Tax Foundation, 2011), 4:1-35, question 6, at 4:7-8, and "Canada Revenue Agency and Revenu Québec Round Table," elsewhere in these proceedings.

94 Paragraph 20(1)(e.2) provides for the deductibility of premiums (or at least a portion of the premiums, in some cases) in limited circumstances. There are a number of requirements for deductibility, including the following: the owner of the policy must also be the borrower; a "specified financial institution" must require the policy as security for the loan; the interest expense must be deductible for tax purposes; and the deductible amount must be the lesser of the premium and the net cost of pure insurance for the policy for each particular year. See *Interpretation Bulletin* IT-309R2, "Premiums on Life Insurance Used as Collateral," February 28, 1995, for additional details.

95 For example, if the policy is expected to be required on a permanent basis (that is, owned for the lifetime of the insured), then the ownership of the policy by an operating company could be problematic when or if that company is ever sold. Transferring a policy out of a company prior to a sale can result in income tax if the cash surrender value of the policy exceeds the adjusted cost basis of the policy (subsection 148(1)). In addition, a potential shareholder benefit issue can arise if the recipient of the policy does not pay fair market value consideration for the policy.

96 The technical issues dealing with the distribution of dividends to a corporate beneficiary are reviewed above under the heading "Investment Holding Companies."

97 As illustrated in the discussion of liquidity, the tax bill will be reduced using post mortem planning. We review other post mortem planning opportunities using corporate-owned insurance later in the paper.

98 For example, in a situation with several insured arm's-length shareholders that are parties to a buy-sell provision in a shareholders' agreement, the beneficiary of the various policies should be the company in which the shares of a departing or deceased shareholder will be repurchased after death.

99 See the definition of "capital dividend account" in subsection 89(1).

100 These numbers are based on a November 2011 illustration from a major Canadian life insurance company. The amounts will vary depending on a number of factors, including the age and health of the insured, the type of policy chosen, the funding period, and the insurance company supplying the product.

101 See CRA document nos. 2004-0065461C6, May 4, 2004; 2007-0241951C6, October 5, 2007; 2009-0347291C6, November 24, 2009; and 2010-0359421C6, May 4, 2010.

102 For example, without dealing with specific numbers and amounts, if a corporation has owned a level cost of insurance term-to-100 policy for 20 years, the policy should have a fair market value of some significance. The fair market value will be that much greater if the insured has had a decline in health. Therefore, if the corporation is distributing the policy to the insured who is, say, a shareholder, subsection 15(1) should apply if the shareholder does not provide consideration to the corporation equal to that fair market value (even though the proceeds of disposition to the corporation are deemed to equal only any cash surrender value of the policy). This issue can often be avoided if the policy is distributed to a corporate shareholder as a dividend in kind—subject to any part IV tax issues and potential implications of subsection 55(2), the shareholder corporation could utilize the intercorporate dividend deduction in section 112 and avoid a subsection 15(1) issue.

103 See subsection 85(1.1).

104 Insurance on both spouses is often referred to as “joint second-to-die” or “joint last-to-die” insurance, with the proceeds paying out on the second death.

105 A number of papers and articles have dealt with the stop-loss rules, grandfathering, and related issues, including William. J. Strain, “Impact of Proposed Stop-Loss Rule on Estate Planning,” in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996), 21:1-23; T.R. Burpee, “The New Stop-Loss Rules: Grandfathered Shares,” Personal Tax Planning feature (1998) 46:3 *Canadian Tax Journal* 678-95; Jim Barnett, Peter Everett, Chris Ireland, and Shelagh Rinald, “Post Mortem Planning for Private Company Shares: The New Regime,” in *Report of Proceedings of the Fifty-Fourth Tax Conference*, 2002 Conference Report (Toronto: Canadian Tax Foundation, 2003), 32:1-95; and Chris Ireland, “Selected Developments in Post Mortem Planning,” in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 13:1-39.

106 As reviewed in detail in the references noted in note 105, grandfathered status can result in no taxes on death and after implementation of the necessary post mortem planning, if there is corporate-owned insurance and a capital dividend account equal in value to the full amount of the shares being repurchased.

107 The stop-loss rules referred to in this paper are in subsection 112(3.2), although the grandfathering rules (branches A and B) are associated with subsection 112(3) in David M. Sherman, *Practitioner’s Income Tax Act 2011*, 40th ed. (Toronto: Carswell, 2011), 755-56.

108 The CRA’s views on modifying a pre-April 27, 1995 agreement and the use of secondary agreements can be found in *Income Tax Technical News* (ITTN) no. 12, February 11, 1998, 7-11.

109 See section 131(12) of the Income Tax Amendments Act, 1997, SC 1998, c. 19.

110 See note 102 supra.

111 For example, as noted by the CRA in ITTN no. 12, supra note 108.

112 This amount is based on the assumption that the full amount of the taxable capital gain is taxed at the highest marginal rate in British Columbia of 43.7 percent, and that any double tax will be avoided by implementing the pipeline planning referred to in note 93 supra.

113 See the references cited in note 105 supra for a detailed review of the 50 percent and 100 percent solutions.

114 As per subsection 112(3.2).

115 In order to avoid the excess capital dividend election rules, the planning may also have to include a paid-up capital increase so the $2 million of capital dividends will be in respect of the full amount of the dividend as required by subsection 83(2).

116 It should be noted that the subsequent use of the capital dividend account could include using promissory notes if sufficient cash is not on hand (particularly if all of the insurance proceeds are used as part of the post mortem planning). It may also be desirable, depending on any terms in the family shareholders’ agreement, to distribute the remaining capital dividend account as soon as practically possible.

117 As per subsection 83(2), regulation 2101, and form T2054.

118 In the case of *Frye v. Frye Estate*, 2008 ONCA 606 (CanLII), the Ontario Court of Appeal considered a clause in a family shareholders’ agreement that contained a number of specific terms and conditions restricting the transfer of shares. A shareholder died and bequeathed his shares to a sibling, seemingly in contravention of the shareholders’ agreement. The court found that the agreement did not prevent the shareholder from bequeathing shares by will. The remedy for the other shareholders was not to invalidate the testamentary transfer, but to sue

the estate for breach of contract. Drafters of family shareholders' agreements may wish to read this case.

119 *Interpretation Bulletin* IT-140R3, "Buy-Sell Agreements," April 14, 1989, paragraphs 2-3.

120 Mark P. Chartrand, a partner in the Vancouver office of Borden Ladner Gervais LLP, has made a number of presentations on the subject of the family shareholders' agreements. In particular, his presentation, "Family Shareholders Agreements: Uses, Advantages and Pitfalls," which was given at the Pacific Business & Law Institute on May 27, 2009, was very helpful in the preparation of this paper.