Tax Notes/Estate Planner – August

Some Thoughts on Estate Plans

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How should a professional advisor approach an estate planning structure for a client and his or her family?

First, my personal preference is to keep it on the simple side. We should not lose sight of the fact that an estate freeze is a long-term structure, which should be able to stand the test of time. For example, over the years, the CRA has provided some comfort on various technical points, often forming the basis of a sophisticated estate freeze structure. But one should look closely at the parameters of such administrative largesse and perhaps even query whether it will continue to exist a couple of decades from now**[i]**.

Sometimes defects can surface or new issues emerge. To give just one example, in the course of updating Tax and Family Business Succession Planning (the 3<SUPRD< sup> edition will be coming out soon), we came across a fairly recent French-language technical interpretation indicating that the CRA apparently has an issue with price adjustment clauses in a stock dividend freeze.**[ii]** Since this form of freeze is something of a rarity, this will be of little interest to most advisors – except of course those who have been using this structure.

Going with conventional structures may be another good move. If you get into esoterica, you may be find yourself swimming upstream one day. For example, it is possible that there could be new legislation that may have an unintended result which could adversely affect the particular structure. If you go with the crowd and it turns out there is a problem with new legislation, there will be lots of others in the same boat; more often than not, the problem will be fixed. If you are off on a tangent, chances are, you may not get the ear of the Department of Finance, much less sympathy**[iii]**.

Changes in the Family

Think about changes to family circumstances. For example, practitioners are often asked to implement freezes for younger entrepreneurs – often with children in their teens or younger. One day the kids may get married – and then divorced. A marriage contract may not always be possible, and recent Ontario case law indicates that proper disclosure may be a more arduous process than we assumed even a few years ago. So the client should be made aware that family law issues could arise. Consideration might even be given to delaying the freeze until the kids get married, at which time better protective strategies may be available.**[iv]** Apart from this, the kids could become successful and establish their own businesses. Consideration should be given to the potential impact and antidotes to the association rules.

Of course, another possibility could be that the kids move to the US or abroad. Until the mid-90s, it was possible to distribute the growth shares of a taxable Canadian corporation to a US or other foreign beneficiary without tax. However, subsection 107(5) now prevents this. For beneficiaries resident in the US, it was frequently possible to deal with this issue by interposing an unlimited liability corporation prior to distribution of the growth shares. But remember that unforeseen legislation I mentioned awhile ago? The Protocol to the Canada-US Treaty has knocked a big hole in this manoeuvre by imposing a 25% rate of withholding on dividends paid by the ULC to the US resident, starting next year. When implementing a family trust, one solution to this is to provide for corporate beneficiaries so as to enable a tax-deferred distribution to a Canadian-resident corporation.**[v]**

Giving Freezor "All the Strings"

> **"We are all men who have refused to be fools, who have refused to be puppets dancing on a string pulled by the men on high" - Vito Corleone**

I think most successful businesspeople would have similar sentiments; the desire for control is one of the common traits of successful businesspeople. How do I know this? When a freeze structure is put forward, concerns about loss of control are usually among the first reactions of the client. How many times have we gone

out of our way to assure a client that when he or she comes to work the day after the freeze, the sun will still be shining – and more importantly, there won't be someone looking over his or her shoulder?

However, a freeze structure introduces other shareholders. And with other shareholders come duties to them on the part of Freezor, often of the highest order - especially since Freezor will often insist on being the director of Freezeco as well as a trustee of his or her family trust. Notwithstanding the fact that there are other shareholders, the owner-manager is often insistent that he or she be able operate and make decisions unilaterally and without question. Naturally, we advisors want to please the client, and we may do everything possible to make sure that this wish is fulfilled. We may give our clients extraordinary voting rights and design clever ways to undo the freeze. We often implement strategies that our client doesn't fully understand - or sometimes doesn't even know about. The control mechanisms we so enthusiastically implement are inherently designed to put Freezor in a position to disregard the interests of other family members. And by giving Freezor all of the strings, he or she will often be inclined to do just that.

As long as there is family harmony, things will be OK. But kids grow up; the family trust arrangement has to be terminated. Maybe the kids have problems. Maybe they are not getting along with their parents. Maybe there are differing views as to whether kids who aren't in the business or whose marriages could be unstable should still get their share of the growth shares.

If things don't go well within the family, minority shareholder rights and remedies may be asserted. Indeed, if Freezor wants to make an "asymmetrical" distribution from the family trust, the prospect of proceedings against Freezor and fellow trustees for breach of fiduciary duty may be very real: a very wise lawyer once told me that discretionary trusts are not as discretionary we may think.

Besides actions by children, giving Freezor all the strings could be problematic in the family law context: in Ontario at least, an estranged spouse might argue that the "bells and whistles" Freezor retains in respect of a frozen corporation may militate in favour of a premium over the freeze value.

If a client is insistent on having all the strings, we typically ask how far are we able to go to please the client and achieve this objective. Maybe another question we should be asking is how far should we go.

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[i] One of the most venerable examples is Question 22 of the 1990 Revenue Canada Round Table, relating to "gels" - i.e., where Freezor is a beneficiary of a discretionary family trust. This question may have morphed into a sense on the part of some practitioners that gels have the blessing of the CRA. However, the question and answer pertained to GAAR. The CRA indicated that, depending on the facts, "other provisions of the Act, such as subsections 56(2), 74.1(2), 74.3(1), 74.4(2), 75(2) and 86(2), may have application." The possible application of subsection 75(2) as well as valuation issues in respect to Freezor's interest in a family trust are discussed in *Tax and Family Business Succession Planning*, the 3rd edition of which is to be published by CCH Canadian Limited later this yearl.

[ii] See Doc. No. 2003-0004125, April 1, 2003.

[iii] One problem that never got fixed was the lack of grandfathering rules for subsection 107(4.1), which normally prevents a rollout from a family trust where subsection 75(2) has ever applied to the trust. But even in this case, prior to this provision, it was probably conventional wisdom to ensure that subsection 75(2) did not apply, even though its effect might not have been very problematic.

[iv] But what if the kids get divorced and remarry?

[v] For some other suggestions in this regard, see *Tax and Family Business Succession Planning*, 3rd edition.