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Family Succession

— Jack Bernstein, Aird & Berlis LLP, jbernstein@airdberlis.com

Very often the family business is the major asset of an estate. It is important to provide for its continuance or sale in order to preserve the value of the estate. The survival of the business may be dependent upon an orderly succession. Creditors and employees of the business must have confidence in the choice of the successor chosen to run the business; otherwise, on the death of the owner-manager, the company's bank loans may be called, suppliers may cease to extend credit, and employees may seek employment elsewhere.

Parents who contemplate transferring a business to children must also have confidence that the children are capable of managing the business. All too often, parents transfer businesses to children who do not have the drive or capabilities of the parents and, as a result, the business declines rather than increases in value.

In determining whether to transfer shares to children, parents must consider such factors as the maturity and business acumen of the children, family relationships, and the fact that the shares will be exposed to the creditors of the children (who, in the event of a marriage breakdown, may include a spouse of a child). In Ontario, under the *Family Law Act*, R.S.O. 1990, c. F.3, shares of an operating company owned by a child would be included in net family property unless the shares were acquired by gift or inheritance after the date of marriage, or the shares were excluded under the terms of a marriage contract.

When the size of the business restricts the number of children who can participate, it is often difficult to choose which child is to enter the business. An important issue is equality, or perceived equality, among siblings. Most parents wish to treat their children equally. Where the business is the major asset of an estate, equalization with children who are not active in the business may entail bequeathing them other assets and/or shares in the company.

When several children, or more than one family, are involved in the business, it may be difficult for parents to be objective in assessing and evaluating their children. Also, such an assessment could prove detrimental to the family relationship.

As long as parents are alive, the children may get along in the business. There is nothing worse, however, than a deadlock situation after the parents' death whereby the children are divided as to the manner in which the business is to be conducted. For this reason, it is recommended that one child be given control over the business and that a shareholders' agreement protect the shareholding children. For example, the agreement may contain

restrictions that preclude the child in control from selling the business or his shares without offering to sell the shares of the other children as well (a piggyback clause).

It may be in the interest of the business to retain strong outside management while permitting the children to own shares and learn the business gradually. The company may have a board of directors or an advisory group made up of successful business executives who have no shareholdings in the company. The mandate of the outside group would be to assist the children in making business decisions and to evaluate the progress of the children.

Some of the advantages of transferring a business to children during the parents' lifetime include income splitting and the possible dissociation of the business so as to enable each company to take full advantage of the small business deduction. This article reviews the methods of transferring a business, methods of retaining control, methods of freezing and of reversing a freeze, and planning on death.

Methods of Transferring a Business

There are several methods of transferring a business to children. These include:

- a gift of existing shares;
- a sale of existing shares; or
- a freeze on the value of the business and an issue of new equity shares to children entitled to the future growth of the business only.

Gifts or sales may be structured to take advantage of the \$500,000 capital gains exemption. If the corporation is a small business corporation, the taxpayer or related parties must have owned the shares of the corporation for more than twenty-four months and more than 50% of the value of the assets of the corporation must have been used in an active business carried on primarily in Canada during that period. A sale of shares to children should take advantage of the capital gains exemption and of the ten-year reserve.

There are several factors to be taken into account in determining whether shares should be given, sold or issued as part of a freeze to children. A gift may have the advantage of being protected from claims by the spouse of the donee. For example, under the *Family Law Act*, a gift and any income derived therefrom may be exempt from an equalization claim by a spouse where the gift was made after the marriage of the donee and was subject to the express condition that income derived therefrom would not be included in net family property. A sale of shares, on the other hand, may be exposed to an equalization claim on the marriage breakdown of a child in the absence of a domestic contract which provides otherwise.

If there are other children who are not to be involved in the business, a parent may prefer a share sale to children in the business rather than a gift, as the purchase price received on

a share sale could be used by the parents to make equalization payments to the other children.

Parents must also consider whether they may require either the purchase price of the shares or continuing income from the business in order to finance their retirement. The parents' needs for the future would have to be considered in structuring a share sale or an estate freeze. A compromise may be to partially freeze the business with the parents taking back some common shares, as well as retractable preference shares, in order to share in the future growth of the business with the children.

The terms and conditions applicable to a share sale may depend upon such factors as whether the parents wish to receive payments as soon as possible or merely to use the balance of sale as a method of exercising control and of equalizing with other children on death. The availability of the deferral on the transfer of a farm business, the unutilized capital gains exemption of a parent and any capital or non-capital losses of a parent are other factors to consider.

An estate freeze enables children to become shareholders and to share in the future growth without having the financial burden. This is not unfair as the children's participation in the future growth of the company should be based, at least in part, on their efforts while permitting the parents to retain the right to be paid for their contribution to the business. Under a freeze, the parents would generally receive shares equal to the value of the business at the time of the freeze. The shares would not increase in value and are thus considered to be frozen.

For Ontario residents, the consent of the spouse of the person effecting the freeze may be required to institute the freeze. Otherwise, the spouse may take the position that the freeze constitutes an act of improvident depletion (in that the future growth of the business is transferred to the children), giving rise to injunctive relief under the *Family Law Act* or other similar provincial legislation. The argument to the contrary is that the freeze reflects the fair market value of the consideration received on the business at that time and that there is no improvident depletion.

Estate Freezes

It is possible to reorganize the shares of a small business corporation so as to accomplish a total or partial estate freeze, and to facilitate income splitting to beneficiaries in lower tax brackets. The estate freeze may be accomplished by a share-for-share exchange under the provisions of section 86 of the *Income Tax Act* (the "Act"), or a crystallization involving a share-for-share exchange using the provisions of section 85 of the Act. In any of these scenarios, the owner-manager would exchange the common shares which he holds in the operating company for fixed-value preferential shares either in the operating company or in a holding company. This could be accomplished on a tax-deferred basis subject to the possibility of crystallizing the unutilized capital gains exemption of the transferor. Assuming that the corporation would be a small business corporation, it would be possible to achieve income splitting either in favour of a spouse (subject to possible

concerns about the general anti-avoidance rules) or in favour of minor children as the provisions in section 74.4 would not apply.

Care must be exercised to ensure that the corporation not cease to be a small business corporation in the future, as the corporate attribution test is applied annually. For example, a problem would arise if the corporation accumulates passive investments, sells the assets of the operating company or makes a substantial investment in the U.S. If more than 10% of the value of the company does not relate to an active business carried on primarily in Canada, the corporate attribution rules will apply if there are designated shareholders (e.g., spouse or minor children). Given the “Kiddie tax” on dividends paid to minor children, an easy solution where there is a concern that the corporation may lose its status is to insert a clause in the trust precluding distributions to a child under age eighteen.

It may be possible to issue discretionary classes of shares in order to facilitate the sprinkling of dividends to different classes of shareholders to the exclusion of other classes of shareholders. For example, a parent may implement an estate freeze by taking back fixed-value preference shares. Separate classes of shares may then be authorized and issued to a trust for children and to the parent. For example, the parent may decide to retain an interest in 75% of the growth of the company and to transfer 25% of the growth to the next generation. In that case, the parent could subscribe for Class A common shares entitled to 75% of the growth plus a discretionary dividend. A trust formed for the benefit of children could subscribe for Class B shares entitled to 25% of the growth plus a discretionary dividend. The trust for the children could be settled by the grandparents in order that the parent may be the sole trustee of the trust. Otherwise, if the parent is both the settlor and the trustee, subsection 75(2) of the Act may apply. If the beneficiaries are minors, the trust must use borrowed funds in order to subscribe to the common shares in the operating company or the holding company. The loan must bear interest at a reasonable rate and it must be paid within 30 days after the end of the year. Typically, the loan would be for a nominal amount (e.g., \$100) and would be repaid, together with accrued interest, out of the first dividend.

Depending upon the province in which the beneficiaries reside, a beneficiary of a trust having no other income could receive dividends of approximately \$30,000 per year free of tax. By using discretionary shares, it would be possible to pay dividends only on the class of shares held by the family trust (rather than also on the shares held by the owner/manager). Another advantage of this structure is that the children would each be able to benefit from their \$500,000 capital gains exemption with respect to shares of the small business corporation in the event that the company is subsequently sold and part of the appreciation is attributable to the shares issued to the family trust.

The use of a trust in an estate freeze of a small business corporation will enable the parents to include all of their children as discretionary beneficiaries. The parents as trustees can subsequently distribute the shares in such proportions as they determine based on each child's involvement in the company. If there is a considerable spread in the ages of the children and it is possible that one or more children may join the business

later, this alternative may be attractive. The use of a discretionary trust would provide flexibility with respect to sprinkling dividends received by the trust among beneficiaries as well as the allocation of capital gains realized on the disposition of the shares. Multiple use would be available for the capital gains exemption. If the children are young at the time the parents decide to implement the freeze, or if one child is active in the business and it is anticipated that another child will also become active, the flexibility afforded by the trust is particularly advantageous.

The fact that the twenty-one year deemed realization may now apply may prove to be an incentive to have the trust roll out the shares to the beneficiaries prior to the twenty-first anniversary. Special planning is required if a beneficiary does not reside in Canada at that time, as the rollout is only available to a beneficiary resident in Canada. If the parent wishes to retain control at that time, the parent may do so through the voting shares that the parent would hold, and by means of a shareholder agreement that the parent could enter into with the trust under the terms of which the rights of the children as shareholders may be further restricted.

If the parent has not utilized his or her capital gains exemption, and on the assumption that the preference shares acquired by the parent on the freeze meet the requirements for the capital gains exemption, it would be possible for the trust, or the adult beneficiaries of the trust, to apply dividends received from the trust to purchase preference shares from the parents. If properly structured, the children would not pay tax on the dividends and the parent could receive the funds free of tax. If the parent wishes to implement a freeze of a corporation (“INVESTCO”) that does not qualify as a small business corporation, then consideration could be given to having INVESTCO roll over its assets to a new corporation in exchange for fixed-value preference shares. The shares of the new corporation could then be issued to a trust for children. If a partial freeze is desired, then the preference shares received by INVESTCO would be entitled to a discretionary dividend and the shares issued to the trust for the children would be entitled to a discretionary dividend. This opportunity is based on the fact that section 74.4 applies only to a transfer of property by an individual and not to an inter-corporate transfer. It is important that the transaction not be back-to-back. In other words, assets should not be transferred to one corporation and then be transferred to another. Alternatively, a partial freeze of the company may be implemented with separate trusts for each minor child acquiring less than 10% of the same class of shares issued to the parent on the freeze. If the trust acquires less than 10%, the beneficiaries would not meet the definition of a specified person. A third alternative, if the corporation is not a small business corporation, is to preclude the distribution of income or capital to beneficiaries under the age of eighteen.

Four Methods of Freezing

There are four methods of freezing the value of the shares of an operating business:

(1) The first method is to reclassify the common shares held by a parent as preference shares having the same value, and then to issue new common shares to the children for nominal consideration.

(2) The second method is for a parent to transfer his common shares in the business to a holding company in exchange for fixed-value preference shares of the holding company. The common shares of the holding company could then be issued to the children for nominal consideration. Provided that family members use their own funds to subscribe for the common shares, the attribution rules do not apply to a share reorganization or to a rollover of shares to a holding company, on the assumption that the operating company and holding company satisfy the definition of a small business corporation. It is assumed for the purposes of this paper that the freeze is in favour of adult children, in which case the attribution rules do not apply.

It may be necessary to obtain consent to the freeze from the spouse of the parent effecting the freeze. Otherwise, the spouse may take the position that the freeze constitutes an act of depletion (in that the future growth of the business is transferred to the children), giving rise to injunctive relief under Ontario's *Family Law Act* or other similar provincial legislation.

(3) A third method is for the operating company to transfer all or part of the assets to a new corporation in exchange for fixed-value preference shares. Common shares of the new corporation are then issued to the children. This alternative enables the parent to transfer a division of the business, or to retain redundant assets, such as the building in which the business is located.

(4) A variation and fourth method is to have the operating company enter into a partnership with a company formed for the benefit of other family members. The operating company can transfer all or part of the business on a tax-deferred basis to the partnership.

Each of these alternatives will be discussed in detail below.

Share Reclassification

All of the common shares held by a parent would be exchanged for a class of preference shares. The preference shares would be deemed to have the same adjusted cost base as the common shares. The preference shares would typically be redeemable and retractable (redeemable at the holder's option) for an amount equal to the fair market value of the common shares immediately prior to the exchange. The retraction feature is generally advocated as a means of avoiding the conferral of a benefit pursuant to subsection 86(2) of the Act, which could result in a tax liability for the transferor. There is no requirement that the shares be voting or participating. The preference shares may yield a non-cumulative monthly dividend (for example, 0.5 percent of the redemption price) in order to afford the parent the flexibility of receiving a return on his investment. The preference shares would otherwise not share in the profits of the business.

In order to preclude an argument by the Canada Revenue Agency (the “CRA”) on the death of the parent that the preference shares (the freeze shares) are worth a premium by virtue of the fact that they carry sufficient votes to control the corporation, it may be prudent to make the freeze shares non-voting and to issue a separate class of new shares to the parent, for a nominal subscription price, which would be voting but non-participating. The voting rights could be restricted to the original holder, so as to enable the parent to retain voting control during his lifetime while countering a potential argument that the shares should be worth a premium on death. Any change to the share attributes of the voting preference shares should require the approval of a majority of the shareholders of each class of shares, voting separately.

The preference shares issued on the reorganization would have the same paid-up capital as the exchanged shares. Otherwise, a deemed dividend could arise pursuant to subsection 84(1) of the Act, since the paid-up capital of the corporation would have been increased without a corresponding increase in net assets. A directors' resolution may be required to make the stated capital (and thus the paid-up capital) of the preference shares equal to the paid-up capital of the old common shares.

The articles of amendment may stipulate that the redemption and retraction price shall equal the fair market value of the common shares immediately prior to the exchange, which value shall be determined by either the accountants of the corporation or the board of directors. The board of directors can then determine by resolution the approximate fair market value of the exchanged shares and thus the redemption price of the preference shares. The directors' resolution could contain a price adjustment clause that would enable the directors to adjust the redemption-retraction price in the event of a subsequent reassessment that is accepted by the board of directors.

As the redemption price of the preference shares would represent the value of the corporation at the time of the exchange, additional classes of shares could be issued for nominal consideration. As indicated above, the parent may hold a second class (or if shares are issued to both parents, one may hold a second class and one a third) of voting but non-participating preference shares as a method of retaining control. New common shares could then be issued to the family members in the desired proportions for a nominal subscription price. It would thus be possible for the parent to implement a partial or total estate freeze. If only a partial freeze is desired, the parent may subscribe for any percentage he wishes of the new common shares.

A share reorganization is advantageous because it is relatively simple to achieve. A second corporation is not required, and no tax election need be filed. This method of transfer enables the parents to retain control over the rights. It enables the children to become shareholders and to share in the future growth without having the financial burden. It is fair, because the children's participation in the future growth of the company is based, at least in part, on their efforts, and at the same time the parents retain the right to be paid for their contribution to the business. The preference shares received by the parents may be bequeathed to other children as a means of equalizing the position of the children who are active in the business. The share reclassification would not enable a

parent to take advantage of the \$500,000 exemption. A parent may, however, elect under section 85 to crystallize the exemption on the share exchange.

Use of a Holding Company

As an alternative to selling the shares directly to children or reorganizing the share capital, the shares held by the parents could be transferred on a tax-deferred basis to a holding corporation in exchange for preference shares pursuant to section 85 of the Act. The children would subscribe for common shares for nominal consideration. The transferor and the transferee would elect that the transfer price be equal to the adjusted cost base of the shares to the parents and an election form would be filed. The agreed amount would constitute the proceeds of disposition of the old shares, the adjusted cost base to the transferee corporation of the transferred shares, and the adjusted cost base to the transferor of the new shares issued by the transferee corporation.

As section 84.1 may apply, it is generally prudent to take back shares of the holding corporation and to ensure that the shares have a stated capital equal to the paid-up capital of the transferred shares. Otherwise, an immediate dividend may be triggered where non-share consideration is received in excess of the greater of paid-up capital of the exchanged shares and the adjusted cost base of the exchanged shares. The paid-up capital of the shares received on the exchange may be reduced where the stated capital of the shares received exceeds the greater of the paid-up capital of the transferred shares and the adjusted cost base of the transferred shares. In situations where section 84.1 does not apply, subsection 85(2.1) deems the shares received on the transfer to have a paid-up capital equal to the paid-up capital of the transferred shares.

The preference shares received by the parents would generally be redeemable and retractable for an amount equal to the fair market value of the transferred shares. This feature is necessary in order to avoid a deemed benefit pursuant to paragraph 85(1)(e.2) of the Act. The deemed benefit may result in an increase in the agreed amount and would thus trigger a capital gain to the transferor.

There is no statutory requirement that the shares be voting or participating. The shares may yield a non-cumulative dividend in order to afford the parents the flexibility of receiving a return on their investment.

Rather than have voting rights attached to the preference shares received on the exchange, it may be preferable to have a separate class of voting but non-participating shares issued to the parents for nominal consideration. The voting rights could be available only to the original holder of the shares. As discussed above, such a restriction may serve to rebut an argument by the CRA on the death of a shareholder that the shares should be valued at a premium.

At the 1980 tax conference, Revenue Canada set out its position with respect to the attributes of the preference shares to be received on a rollover. The department's position is that the preference shares must be redeemable at the option of the holder. The

preference shares should be entitled to a dividend. In any case, the dividend must not exceed a reasonable amount. The shares may or may not have voting rights; however, such shares should at least have voting rights on any matter involving a change to the rights, conditions, or limitations attached to them, sufficient to protect those rights. It is essential that the value be maintained; accordingly, there are other rights that must be attached to the preference shares, such as a preference on any distribution of the assets of the corporation on any liquidation, dissolution, or winding up, and no restriction on the transferability of the shares (other than restrictions required by corporate law to qualify the company as a private company). In addition, the company must undertake that no dividends will be paid on any other classes of shares which would result in the corporation's having insufficient assets to redeem its preference shares at the redemption amount.

If the shares to be transferred to the holding company have declined in value, a capital loss will not be available where the shares are transferred to a corporation controlled directly or indirectly by the taxpayer or his spouse. The disallowed loss would be added to the adjusted cost base of the shares taken back from the holding company.

Asset Transfer

A corporation may have more than one business, and a parent may wish to transfer all or part of one business to a child or to transfer separate businesses to each child. Similarly, a corporation may have investment or redundant assets in addition to business assets. For example, a corporation may own the building used in the business as well as other investment assets. The parent may wish to retain the real estate and other investments both to provide for an income on retirement and to provide assets that may be used to make an equalization payment to children not active in the business.

The operating company could transfer the assets, in respect of which the children are to participate, to a new corporation, the common shares of which would be subscribed to by the children for nominal consideration. An election would be filed pursuant to section 85 of the Act so as to transfer the assets at their net tax values in order not to trigger a tax liability to the operating corporation. In consideration for the transfer of assets, the operating corporation could receive preference shares in the new corporation which would have an adjusted cost base equal to the elected amount. The preference shares may be redeemable and retractable for an amount equal to the fair market value of the assets transferred minus any liabilities assumed. Liabilities should not be assumed in excess of the cost amount (tax cost) of the transferred assets. Otherwise, the elected amount would be increased by any excess and a tax liability may be triggered. The preference shares should be retractable for an amount equal to the fair market value of the transferred assets (net of any liabilities assumed) in order to avoid a bump in the elected amount. Subsection 55(2) of the Act should not apply to deem any portion of the redemption proceeds to be a capital gain by virtue of the non-arm's length relationship of the parties.

Any dividend arising on the redemption of the shares should be exempt from Part IV tax on the basis that the corporation is controlled by persons who do not deal at arm's length

with the operating company. The preference shares would have a low paid-up capital so as to ensure that a dividend would arise on the redemption. There is no statutory requirement that the preference shares be participating as to dividends.

The half-year rule for claiming capital cost allowance will not apply to assets acquired from a non-arm's length party or pursuant to a rollover, provided that the assets were owned by the transferor at least 364 days before the end of the taxation year during which the taxpayer acquired the property.

If depreciable assets are transferred by an operating corporation to a non-arm's length corporation, the capital cost of the property to the new corporation shall be deemed to be an amount equal to the aggregate of the cost of the property to the operating corporation and one-half of the amount by which the operating company's proceeds of disposition of the property exceeds the cost, or capital cost, to the transferor immediately before the time of transfer. In other words, if the operating company owns depreciable property that has appreciated in value and it transfers the property to the new corporation for more than its cost (e.g., an election is not made under section 85 for a complete deferral), the cost of the property to the new corporation will be limited to the original cost to the transferor plus one-half of the difference between the purchase price and that original cost.

Use of a Partnership

Another alternative would be to have the operating corporation transfer assets into a partnership that would comprise the operating corporation and a corporation owned by family members or alternatively family members directly. In the latter case, a limited partnership may be advisable in order to restrict the liability of family members. An election would be filed pursuant to subsection 97(2) of the Act so that the assets could be transferred at their tax values. Family members, or a family-owned corporation, may have to make a significant contribution to the partnership in order to justify an income allocation to them.

Subsection 103(1) of the Act provides that where the principal reason for the income or loss allocation in a partnership agreement may reasonably be considered to be the reduction or postponement of the tax that may otherwise become payable, the share of each partner will be adjusted to an amount that is reasonable having regard to all the circumstances, including the proportions in which the members have agreed to share profits and losses of the partnership from other sources or from sources in other places. In the event that the partners do not deal with each other at arm's length, the income or loss allocation must be reasonable in the circumstances, having regard to the capital invested in, or work performed, for the partnership by the members thereof, or such other factors as may be relevant. If the allocation is not reasonable, it may be readjusted.

If a family corporation is a partner, it may be argued that the family corporation has taken over the operating responsibility for the partnership, thus justifying an income allocation. Where family members are involved as limited partners, they may not play an active role in the partnership without risking the loss of their limited liability. In that instance, it

would be necessary to have the limited partners make a capital contribution to the partnership in an amount sufficient to justify the acquisition of the partnership interest. The amount of the contribution would depend upon the value of the business being transferred. Funds could be loaned to family members for the purpose of enabling them to acquire a partnership interest.

Any capital contributions made to the partnership by the family corporation or family members could be withdrawn on a tax-deferred basis by the operating company. A tax liability would arise only on the disposition of the partnership interest.

If the partnership interest gives rise to income from a business rather than income from property, family loans should not give rise to income attribution. In the case of a trust, the CRA has confirmed in a private interpretation letter that subsection 108(5) of the Act does not extend the attribution rules to apply to business income earned by a trust.

If the parent who owns the shares of the operating company loans funds to a family member to enable a family member to make a capital contribution to the partnership, the CRA may try to attack the subsequent allocation of the income, although the department's position would be shaky given the fact that the parent is not directly a partner in the partnership. In Interpretation Bulletin IT-231R2 "Partnerships — Partners not dealing at arm's length", the CRA takes the position that a loan by a partner to a spouse for the purpose of enabling the spouse to make a capital contribution to the partnership should be viewed as a capital contribution by the partner rather than by the spouse.

Control

When children become equity owners of the business, parents lose some control since children acquire the legal rights of shareholders or business partners. Parents wish to retain control, in most instances, as long as they are active in the business or, in some cases, throughout their lifetime.

When an estate freeze is implemented whereby shares of the operating company are reclassified or transferred to a holding company in which family members are involved, there are several methods of retaining control.

Rather than having voting rights attached to the freeze shares, which may give rise to an increased tax liability on death, a new class of voting preferred shares would be issued to the parents for a nominal subscription price at the time of the freeze to permit them to retain control. Both parents, for example, may be issued a sufficient number of voting shares to ensure that they retain voting control over the company during their lifetimes. In order to avoid any tax problems on death concerning the valuation of the voting preference shares, the shares may be non-participating (not entitled to dividends) and voting in the hands of the original holder only. The 1987 Ontario Court of Appeal decision in *Bowater Canadian Limited v. R.L. Crain and Craisec Ltd.* put some doubt on the validity of this restriction. However, it may be possible to distinguish *Bowater* by having a separate class of shares issued to each parent. It is arguable that no other

shareholder would be prejudiced by the share restriction. The shares would cease to be voting once they are transferred to the estate. This protects children active in the business from having other family members gain control. It also prevents the CRA from arguing that those preference shares are worth a premium on death so as to increase the capital gain, if any, arising on death.

Alternatively, the separate class of voting shares (which need not be voting in the hands of the original holder) may be issued to a trust formed for the benefit of the parents and, on their death, for their children. The trust may enable the parents to designate the proportionate distribution of the voting shares on death. For example, the majority of the votes may be bequeathed to the child who is to be president or to children who are resident in Canada.

On a freeze, common shares may be issued to a trust for children rather than to the children directly. Parents or their nominees may be trustees, thus completely precluding the children from exercising any rights as shareholders.

The use of a trust would enable the parents to include all of their children as discretionary beneficiaries, if that is desired. This permits the parents to distribute the shares subsequently in such proportions as they determine desirable based on the children's involvement in the company. If the children are of different ages and it is possible that other children will join the business, this alternative may be attractive. The use of a discretionary trust would provide flexibility with respect to income splitting of dividends received by the trust as well as the allocation of capital gains realized on the disposition of shares. If the children are young at the time that the parents decide to implement the freeze or if one child is active in the business and it is anticipated that another child will also become active, the flexibility afforded by the trust is particularly advantageous.

The assets of the trust, including the shares of the business, may be protected from creditors of the discretionary beneficiaries (at least until their interests are vested) or, depending upon the applicable provincial law, from spouses of children. The *Family Law Act* contains a broad definition of property that may be subject to division. The definition includes any interest — present or future, vested or contingent, in real or personal property — and may therefore include an interest in a trust. It may be possible to avoid exposing the shares to the spouses of the children by having the parents subscribe for the common shares issued on the freeze and then immediately give the shares to the children, or to the trust for children, on the condition that the shares and any income derived therefrom be excluded from the net family property.

Death of a Child

In order to ensure that family members in the business maintain control, it is essential that the voting rights attached to the shares owned by the children not pass to third parties on the death of a child. The assumption is generally made that children will outlive their parents and all of the planning focuses on that eventuality. It is possible, however, that a child will predecease a parent and, especially when the parent does not hold a separate

class of voting shares, arrangements should be made for the parent to retain voting control over the shares of the child in that situation. In other words, the shares may pass to the heirs of the child but the parent may exercise the voting rights attached to the shares. This may be accomplished by means of a shareholders' agreement.

The parent may be afforded the option of retaining or selling the business on the death or disability of a child. If it is likely that the child's estate will require immediate liquidity on death, then corporate-owned life insurance may be obtained and used to buy shares from the child's estate.

If the child is married and wishes to bequeath the shares to a parent, reference should be made to the relevant family legislation. In Ontario, a surviving spouse may elect to take an equalization payment under the *Family Law Act* in lieu of a bequest under the will. The value of the shares would be included in net family property for the purpose of calculating the equalization payment. If the assets of the deceased, other than the shares, are inadequate to make the equalization payment, it is possible that a court may prevent the specific bequest by the child to a parent. The *Income Tax Act* provides for a rollover where farm property or shares of a small business corporation, previously subject to the farm property deferral or the \$200,000 capital gains deferral, are bequeathed to a parent on the death of the child.

Reversing the Freeze

While a parent may be thrilled at the prospect of a child joining the business and may readily agree to transfer existing shares, or to issue new shares after a freeze, to children, family relationships may deteriorate, a child may leave the business or a child may encounter financial problems with creditors or an estranged spouse. In each of these situations, a parent may wish to reverse the freeze.

One method of structuring a reversible freeze is to have the common shares, issued as a result of the freeze, to a trust for the benefit of the children and the parents. The children would be income and capital beneficiaries. The parents may be the trustees and may be included as contingent capital beneficiaries provided that a grandparent is the settlor, otherwise subsection 75(2) may pose a problem. For purposes of association, the capital beneficiaries would be regarded as the owners of the shares. The trust may provide that the common shares are to be distributed to the parents on the occurrence of certain eventualities (if, for example, the child ceases to be an employee or becomes insolvent). A personal trust will enable the shares to be held for the benefit of the children and ultimately to be distributed to the children or to the parents on a tax-free basis.

If, instead of interposing a trust, the child owns the shares issued on the freeze outright and on a disagreement transfers them to a parent, the child may realize a capital gain (which may be wholly or partly sheltered by the capital gains exemption).

As a result of the *Bowater* case in Ontario, concern has been expressed about the use of shares with attributes that are restricted to the original holding. There is also the concern

that if the parent does an estate freeze, and has shares with full voting rights, the CRA may attempt to argue that shares are worth a premium on death. One way of mitigating against this would be to provide in the shareholders' agreement that the shares are to be purchased for cancellation for their subscription price on any transfer and that the share attributes cannot be altered without the consent of all of the shareholders. Another alternative would be to have a separate class of voting shares issued to an *inter vivos* trust for the benefit of the parents during their lifetime and then for the children on their death. The parents would be the trustees of the trust. Income attribution would not be of concern if no dividends are paid on these shares. This would enable the parents to continue to retain voting control over the company without the shares forming part of their estate.

Another method of achieving a reversible freeze would be to have the parent take back fixed-value preference shares (Class A preferred shares) on the estate freeze. A new class of common shares would be issued to the trust for the benefit of the children. A separate class of preference shares (Class B preferred shares) would be issued to a trust for the benefit of the parents. The Class B preferred shares would be non-voting and non-participating as to dividends. However, the shares would be convertible at any time on a one-for-one basis to common shares. As the shares would be issued at the time of the estate freeze, it is arguable that the shares would have no value. The shares would be held by a trust formed for the benefit of the parents and would not form part of the parent's estate on death. If the trust for the benefit of parents exercises the right of conversion, the Class B preferred shares would be exchanged on a tax deferred basis pursuant to section 52 of the Act for common shares so as to dilute the ownership interest of the children, thus effectively reversing the freeze.

An alternative method of reversing the freeze is to have the common shares, issued as a result of a freeze, to a trust for the benefit of the children. The parents may be trustees and may be included as contingent capital beneficiaries (provided a grandparent is the settlor). The trust may provide that the common shares are to be distributed to the parents in the event of certain circumstances (if, for example, the child ceases to be an employee or becomes insolvent). The trust vehicle enables the shares to be held for the benefit of the children and ultimately to be distributed to the children or to the parents on a tax-free basis. If, instead, the child owns the shares outright and on a disagreement transfers them to a parent, the child may realize a capital gain (which may be sheltered by the capital gains exemption).

Another possibility is to retain the right in a unanimous shareholders' agreement to structure a second freeze. This permits the parents to freeze the shares previously issued to children and to take new common shares entitled to future growth. While not reversing the freeze, it limits the effect of the freeze to the growth of the business from the date of the first freeze until the date of the second freeze.

As a precondition to effecting an estate freeze in favour of married children, the spouses of the children should be required to enter into a marriage contract excluding the shares of the business from any future property settlement. If children are married and are subject to the *Family Law Act*, common shares issued on a freeze initially may be

acquired by parents and then given immediately to the children in order that the shares not constitute family assets.

Planning on Death

The parents' wills should be structured so as to use the unutilized capital gains exemption. This may be accomplished either by way of a bequest to children or by an election to transfer the shares to a spouse at fair market value.

Most parents wish to ensure the continuance of the business after their death and to minimize disputes between children involved in the business and inactive children. In most cases, parents wish to divide their estate equally among their children. The children active in the business may receive all, or a majority, of the shares of the business while other children may be given other assets. Family members who are not involved in the business may want to maximize the cash flow they receive from the corporation. The repayment of shareholder loans and the retraction of preference shares may place too great a financial burden on the business.

Protecting the Business

To protect the business, all shareholder loans made to the company should be made payable under predetermined terms on the death of a shareholder. Shareholder loans that were otherwise payable on demand, for example, could be made payable after the death of the parent over ten years with a predetermined interest factor. Similarly, retractable preference shares issued to a parent on a freeze could cease to be retractable and become redeemable over a specified number of years, and yield a cumulative dividend after the death of a parent.

If a building in which the business is operated is owned outside of the operating company, provision should be made for a long-term lease at predetermined rent in the event that the ownership of a building is to be acquired by inactive children. The operating company should be given the right of first refusal to acquire the building. Otherwise, the inactive children may apply pressure to significantly increase the rent or to sell the building.

Family Shareholder Agreement

Protection is also required for the inactive children. If children are to receive a minority interest in the business, the active children having control should not be permitted to sell their shares without offering the shares of the minority children under the same terms and conditions. These and other restrictions should be incorporated in a shareholders' agreement to be entered into by the children. It is imperative that children be required to enter into a shareholder agreement that would define, among other things:

- (1) the composition of the board of directors;

(2) the present and future officers of the corporation (who is to become the president on death of the parent; can the corporation have more than one president?);

(3) all salaries and bonuses (the parent determines such during lifetime, and on death provide equal salaries for all children in the business?);

(4) limited marriage contracts to protect the business by having spouses agree either that shares of business are not family property or, alternatively, that any settlement under family law legislation will not be satisfied with the shares of the corporation;

(5) any life insurance on lives of children to fund buy-out on death;

(6) any life insurance on life of parent to ensure that surviving parent has assets after death and to provide for equalization with other children;

(7) the buy-out provisions after the death of the parent, including any;

(i) right of first refusal;

(ii) shotgun clause; and

(iii) auction clause;

(8) options to buy on insolvency, marital breakdown (if son-in-law or daughter-in-law in business), disability, breach of contract, or if a *Family Law Act* application is launched against the company;

(9) forced sales;

(10) piggy-back clauses;

(11) matched bids;

(12) butterfly options.

Will Planning

On the death of the parents, the balance of the common and preferred shares held by the parents may be distributed to both active and inactive children. This may lead to a conflict of interest between the children in the business and the children not in the business. One possibility is to provide for a freeze to take place on death. The will may require that the common shares held by the parents, which are to be bequeathed to inactive children, be converted on or after the parents' death to fixed value preference shares that would be non-voting, redeemable over a specified number of years, and yield cumulative dividends. The redemption price would reflect the fair market value of the parents' shares at the time of death. Such a reorganization should minimize conflicts

between active and inactive children while ensuring that inactive children receive a fair return on their investment.

For Ontario residents, the bequest should specify that the income to be derived from the shares does not constitute net family property.

Shares may have been given to active children during the lifetime of the parents. The parents, for example, may have taken advantage of the \$500,000 capital gains exemption by giving shares to children active in the business during the parents' lifetime. To achieve some equalization, the will may provide that for purposes of determining the quantum of each child's share, the value of the estate shall be notionally increased by the value of the shares previously given to the children who are active in the business. Each child is then entitled to an equal share of the grossed-up estate. Included in the active children's share of the estate would be the value of the shares previously given to them as well as the shares left to them in the will. This is known as a hotch pot clause. Care must be exercised in drafting such a clause to ensure that any increase in the value of the shares attributable to the children's efforts, from the date that the child acquired the shares until the date of the parents' death, not reduce the child's inheritance. Parents may consider a further reduction given the risks associated with the share investment compared to the other assets (e.g., real estate) to be bequeathed to the other children.

The transfer of a family business to the second or third generation requires a close review of the family's entire personal and economic circumstances. The interests of the parents, the active and inactive children, and of the business must be taken into account. Careful tax planning at the outset can ensure that these objectives are achieved at a minimum cost.

In closing, I am reminded of two quotations and would like you to consider them in the context of family succession.

Firstly, by James Baldwin:

Children have never been very good at listening to their elders, but they have never failed to imitate them.

And secondly, from a Middle Eastern proverb:

Live together like brothers, do business like strangers.