Tax Notes/Estate Planner – January

Will Family Case Affect Freeze Strategies?

By: David Louis, J.D., C.A., Tax Partner

Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

_____

Estate planning – and estate freezes in particular – should stand the test of time. While changes in tax laws are often perceived as the culprit that can kayo a long term plan, a recent family law case is a reminder that other developments may also be problematic.

In a nutshell, the McNamee case**[1]** - which dealt with a division of property under Ontario's Family Law Act - involved a holding company freeze, whereby father transferred shares in "Opco" to "Holdco" in exchange for freeze shares, subscribed to common shares of Holdco for a nominal amount, then gifted the shares to his two sons.**[2]** But notwithstanding a formally-documented gift, the estranged wife of one of the sons contested the claim that the shares should be excluded from net family property as a gift after marriage.

The freeze structure was somewhat atypical**[3]**. Rather than use the umbrella of a discretionary family trust, the growth shares were transferred directly to the adult children. While the court indicated that the retention by father of voting control was also "unusual", we all know better. More unusual was a discretionary dividend feature on the freeze shares that father insisted on, so as to be able to strip the company**[4]** (this could also result in a "control premium" issue)**[5]**. The court emphasized father's motivation to retain control, and the great lengths he went to in order to do so. In the end, this led to ruin.

The husband's lawyer stressed that the orders requested by the wife "would:

1. change the definition of "gift". . .;
2. overturn our orderly process for property equalization and replace it with palm tree justice;
3. create unexpected uncertainty in the integrity of thousands of corporate freezes and hundreds of thousands of wills."**[6]**

Nevertheless, the court held that the gift was invalid for exclusion under Ontario family law.

Elements of a Gift: Deep-Sixed

The court concluded that there are six essential elements of a gift which apply to the Family Law Act:

1. capacity of the donor;
2. intention on the part of the donor to transfer the property without consideration, without the expectation of remuneration;
3. the intention of the donor must be "without conditions, from detached and disinterested generosity, out of affection, respect, charity or like impulses and not from the constraining force of any moral or legal duty or from the incentive of anticipated benefits of an economic nature", rather than being "solely a sophisticated tax planning transaction."**[7]**
4. the donor must divest himself of all power and control over the property and give such control to the donee;

5. there must be intention on the part of the donee to accept the property as a gift; and

6. delivery by the donor to the donee must be completed.

The onus was on the husband to prove that the transfer of the shares from father satisfied each of these elements.**[8]**

The court held that the onus was met with only the first and last**[9]** elements. In the case itself, element #5 (intention to accept the property as a gift) was problematic in that the husband was not aware of the fact that the property was a gift until after separation. This is not particularly problematic for estate planners**[10]**; but other elements in the "required list" will be.

With respect to element 2, the court found that, rather than transferring the growth without consideration, the motivation was for father to continue to control his company and be able to realize the freeze value.**[11]** The court observed that "it is clear on the evidence that [father] wanted the company to continue to operate as he had operated it. This included his sons remaining as employees of a valuable business."**[12]** In this way, father was assured to be paid-out**[13]**. Accordingly, father received consideration for the "gift".

Implicit in the foregoing was the expectation that his sons would continue to work in the business. In McNamee, the shareholder's agreement stipulated that, in the event that this was no longer the case, the growth shares would be converted so as to eliminate future appreciation**[14]**.

With respect to element 3 – that the intention must be inspired by affection and the like, not sophisticated tax planning - the court found that the very fact of seeking to exclude the shares from division of property was problematic in this respect.**[15]** The court also stated that:

The evidence establishes that [father] agreed to the estate freeze to accomplish the objective of creditor proofing his business to protect its continued success**[16]**. He agreed to the plan only on condition that he maintain all of his control so he could continue to operate as he chose, retain the sole power to pay himself income, dividend, bonus and redeem shares and benefit in any future sale proceeds.**[17]**

Therefore, father had not given his sons the usual benefit of an estate freeze, namely the benefit of future growth in the company.**[18]**

Holding "All the Strings"

Element 4 – that the donor must divest himself of all power and control over the property – may be particularly problematic to some estate planners. In essence, the court concluded that this was not the case because the structure involved father "holding all the strings".**[19]**

In this respect, the court cited the sons' lack of control in influencing the election of directors, the direction of the corporation, the amount or frequency of dividend payments and the sale of all of the shares of the corporation.**[20]**

Also cited was the shareholder's agreement**[21]** which provided that:

- father was the sole director and officer of the company;

- by virtue of his voting shares father controlled the making of changes to the authorized or issued capital, articles, by-laws, the hiring of accounting firms, the payment of dividends and other specific provisions requiring the approval of the shareholders including the transfer of shares**[22]**; and

- after the payment of liabilities, the profits be first applied to the redemption of father's shares.

It is submitted that most or all of the foregoing features are common to many estate freeze structures: while father's right to discretionary dividends is unusual, structures devised to allow Freezor to hold "all the strings" are not.**[23]** Rather than give the growth shares outright to children, a typical freeze structure will, of course, involve the protective element of a family trust. Furthermore, the trust will often provide for a "bail-out" feature and allow Freezor to replace the trustees. So was the protective control in McNamee unusually strong, or just somewhat different from the typical freeze structure?

Having said all this, I am probably reading the McNamee case "like a tax lawyer" – looking for across-the-board principles rather than facts: I have been assured by a leading family lawyer that such cases are largely fact driven. In McNamee, the court stressed that the separated couple intended "to be equal in all respects and that each of them maintained that commitment in thought and deed until the day of separation"**[24]** (including in respect of the shares in question)**[25]**. In addition, it is also possible that the court was motivated by the couple's "straight-up" behavior toward one another, rather than contriving to get the upper hand by resorting to sophisticated financial and legal strategies.

Perhaps (hopefully?) the distinction in McNamee from a typical freeze centers around the court's view that father never intended to give his sons any meaningful role in the destiny of the company, nor provide any real rights to future growth - as distinct from structures which provide these, but with safeguards for Freezor**[26]**. But where do you cross the line? On a more straightforward reading, the court held that, for an effective gift, each of the factors listed above must be satisfied. Although the loss of appreciation rights is seldom explicit in a freeze, it is often "expected" that the children will continue to work in and contribute to the business. Could building in asset and Freezor "protection" features, as well as exclusion from family law division-of-property requirements, undermine the requirement of "disinterested generosity"? Finally there is the premise that structures set up to make sure that Freezor "holds all the strings" can be problematic – i.e., because a donor must divest himself of all power and control over the property. Even though McNamee may have been fact-driven, the possibility that such structures could lead to the loss of family law protection may cause at least some practitioners to think twice about them.

David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. David's practice focuses on tax and estate planning for entrepreneurs and their corporations (dlouis@mindengross.com**).**

---

[1] *McNamee* v. *McNamee*, 2010 ONSC 674.

[2] The facts in the case are more fully discussed in a recent article by Robert Spenceley ("'Gift' of Estate Freeze Shares Had Too Many Strings Attached", *The Estate Planner*, December 2010.)

[3] And perhaps somewhat "unsophisticated": besides the fact that a trust was not used, there is nothing in the case that suggests that "thin-voting" shares were considered, even though the redemption of the voting freeze shares to the point of loss of control was an issue with father.

[4] Paragraph 103.

[5] As readers will be aware, the CRA articulated its views on the control premium issue at the 2009 Round Table at the Canadian Tax Foundation Conference. The "official response'" by the CRA in respect to voting non-participating shares now appears on the Canadian Tax Foundation's website, as follows:

> The question arises in the context of estate freezes of private corporations, where the freezor desires additional security for the value of the freeze shares taken back. 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.

[6] Paragraph 175.

[7] Paragraph 215.

[8] Paragraph 215.

[9] Paragraph 283.

[10] For example, a signed acknowledgement could be obtained. Also, the issue may be less likely to arise if a family trust is used.

[11] Paragraph 220.

[12] Paragraph 221.

[13] Paragraph 222.

[14] Paragraph 154.

[15] Paragraph 232.

[16] The creditor-proofing motivation was stressed a number of times. But there is little insight as to how the freeze reorganization would fulfill the creditor-proofing objective. It is unclear whether the creditor of concern was the CRA in respect of death tax, as avoidance thereof was not stated to be a primary objective (see paragraphs 95 and 238). If the "creditors" were the spouses of the sons, the freeze need not have been implemented to begin with.

[17] Paragraph 240.

[18] Paragraph 235.

[19] Father insisted on rewording the gift so that the shares were given to each son on condition that they shall remain the son's "separate property, free from the control of his spouse".

[20] Father testified that he would stop redeeming his shares as he approached the point of losing control of the company.

[21] The agreement was observed by the court to be "somewhat redundant given that by the amended Articles of Incorporation, [father] holds 95% of the voting shares" – see paragraph 154.

[22] The foregoing is specifically cited by the court as being contained in the shareholder's agreement. See paragraph 251.

[23] See "Some Thoughts on Estate Plans", by the author, *Tax Notes* No. 559, August 2009.

[24] Paragraph 78.

[25] Paragraph 275.

[26] An example of where latter intention was found to be applicable is *Laflamme*, 2008 DTC 4829 (TCC), in which father held a class of shares with a conversion right that would dilute the value of growth shares held by a family trust down to virtually nil. However, the Court disregarded this right indicating that, in a ''real life'' situation, a third-party purchaser would have insisted that the father waive the conversion right, and that he would have readily done so, in view of his intention to benefit his family.