GARDINER ROBERTS

Tax and Fiscal Commentary

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Asset Protection Planning Part 2

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This is the second part of a two-part article on asset protection planning, and reviews various asset protection planning strategies and transactions available to individuals and to corporations and their shareholders, and includes a discussion of the use of trusts.

Each of the following strategies and transactions must be considered in the context of the legal rights and remedies described in Part 1 of this article and available to creditors and trustees in bankruptcy to attack unlawful payments and transfers of property.

Asset Protection Planning for Individuals

Limit Liability From the Outset

It is obviously preferable to limit or avoid individual liability and exposure to creditors and other claims from the outset by structuring an individual's affairs in a manner which results in this limitation or avoidance. An individual who has assets to protect should consider not incurring any liability for business loans, leases or other obligations, either directly or by way of guarantee, or should seek to expressly limit his or her liability to any particular creditor to a maximum dollar amount. To the extent possible, an individual should negotiate with a creditor so that the creditor's rights are non-recourse to the individual and, where

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an individual is one of several debtors, so that the individual's liability be several rather than joint and several with the other debtors.

An individual considering becoming a director of a corporation or a partner in a general partnership should be aware of the statutory and common law liabilities of directors and partners. Prior to becoming a director of a corporation, an individual should, (i) confirm his or her indemnity rights under the applicable corporate statute, (ii) consider requesting and obtaining a more expansive indemnity covenant from the corporation directly, and (iii) consider requiring that the corporation obtain directors' and officers' insurance, although this insurance may be expensive.

An individual considering becoming a partner of a general partnership should consider whether it is possible to structure the partnership as a limited partnership. As a limited partner of a limited partnership, the individual's liability would be limited to the individual's capital in the partnership, however, the individual might be entitled to the same income rights as a general partner of the partnership.

Securing Business Loans

An individual who loans funds to a corporation, trust or partnership, or otherwise becomes a creditor of a corporation, trust or partnership, should consider obtaining appropriate security for the repayment of the debt owed to him or her at the time of its coming into existence.

Transfers of Property (Including a Principal Residence) to Family Members

An individual who may become exposed to liabilities and third party claims should, where appropriate, consider transferring his or her assets to one or more family members who are not otherwise exposed to significant creditor liabilities or claims, and who are unlikely to become exposed to such liabilities or claims in the future. Any such transfer must be absolute, with the transferor divesting his or her entire interest in the property. A transferor must accordingly consider the stability of his present and future relationship with the transferee(s).

Gifts or transfers of property to family members at less than fair market value may be attacked under the *Assignments and Preferences Act* (Ontario) ("APA"), the *Fraudulent Conveyances Act* (Ontario) ("FCA"), and the *Bankruptcy and Insolvency Act* (Canada) ("BIA") as described in Part 1 of this article where the transferor is insolvent or near insolvency at the time of the transfer.

However, transfers of property to family members at fair market value, that is for good consideration, may not be attacked where they are otherwise made in good faith. The subsequent forgiveness though of the balance of the purchase price owing in respect of an otherwise fair market value sale of property to a family member may be attacked.

In addition, a transfer of property (including an interest in a principal residence) may avoid attack where the transfer is in respect of a spouse's right to a division of net family property under applicable provincial family law legislation.

Where an individual is solvent, and the creditor relief provisions of the APA, FCA and BIA are unlikely to apply, an individual gifting or transferring property to a spouse or a common-law partner or a minor child, niece or nephew (less than 18 years old) must in any event consider the attribution rules in sections 74.1, 74.2 and 74.5 of the ITA. Generally, gifts and transfers of property at less than fair market value to a spouse, common-law partner, or a minor child, niece or nephew (less than 18 years old) result in the attribution to the transferor of income and capital gains, in the case of a spouse or common-law partner, or income in the case of a minor child, niece or nephew arising from the transferred property or property substituted for it.

As stated above, a transfer of property for fair market value to a spouse or common-law partner or a minor child, niece or nephew, and in good faith, will generally avoid attack under the FCA, APA and BIA, and will avoid the attribution rules in the ITA. If any portion of the purchase price is due after closing, the payment terms should be commercially reasonable (in order to avoid the debt being found to have a fair market value less than its principal amount) and should not be forgiven at a later date. In order to avoid attribution, the debt must bear interest at the lower of the prescribed rate and a commercially reasonable arm's length rate at the time the debt arose, and interest must be actually paid no less than annually by January 30 after each calendar year in which the debt is outstanding.

A transferor may, however, accept the attribution of income and capital gains to him or her under the attribution rules where the transfer of property otherwise results in the protection of the property from the transferor's creditors.

Where an individual gifts or transfers property at less than fair market value to a non-arm's length transferee, the donor/transferor is deemed under paragraph 69(1)(b) of the ITA to have received proceeds of disposition equal to the fair market value of the property, and is subject to immediate tax on the resultant capital gain and recapture, if any. A non-arm's length transferee of gifted property is deemed to have acquired the gifted property at its fair market value.[1] However, there is no step-up in cost base where a non-arm's length purchaser purchases property at less than its fair market value.

There is an exception to the rules in section 69 where the gift or transfer at less that fair market value occurs between spouses or common-law partners. Section 73 of the ITA deems the gift or transfer of capital property to take place at the transferor's cost, unless the transferor elects otherwise. The rollover in subsection 73(1) applies not only to a transfer to a spouse or common-law partner, but also to a transfer to a former spouse or former common-law partner in settlement of rights arising out of the marriage or common-law partnership.[2] The attribution rules continue to apply to income and capital gains arising from the transferred property where fair market value is not in fact paid by the transferee spouse.

Protecting Gifts and Transfers of Property From Spousal Claims

Under the *Family Law Act* (Ontario) ("FLA"), property (other than a matrimonial home) acquired by a gift or inheritance after the date of marriage is "excluded property", and not included in a spouse's net family property for the purposes of the division of property rules in the FLA. Also excluded is income from such property (which includes the appreciation in value of such property) if the donor or testator has expressly stated that it is to be excluded from a recipient's net family property.

Accordingly, deeds of gift for gifts to married children should expressly exclude from the recipient child's net family property income and appreciation arising from or in respect of the gifted property or property substituted for it. Wills and trust deeds should contain similar express exclusion statements.

A parent might loan on a secured basis, rather than gift, funds to a child to purchase a matrimonial home in order to exclude the equity in the home securing the loan from a child's/spouse's net family property.

Conversion to Assets Which are Exempt from Seizure

Under subsection 196(2) of the *Insurance Act* (Ontario), a life insurance contract and the insurance proceeds payable under it will be exempt from execution or seizure by a creditor where the insured irrevocably designates as the beneficiary of the life insurance contract a spouse, child, grandchild or parent of the insured. It may be possible to designate irrevocably an inter vivos trust to receive the insurance proceeds where the beneficiaries are the life insured's spouse, child, grandchild or parent. The life insured may be one of the trustees, and the trust may be discretionary to the extent that the trustees have the power to identify to whom the life insurance proceeds will be distributed upon their payment to the trust.

Subsection 196(1) of the *Insurance Act* (Ontario) provides that, where a beneficiary is designated, the insurance money is not part of the estate of the insured and is not subject to the claims of the creditors of the insured from and after the time of the death of the life insured.

RRSPs and RRIFs issued by insurance companies are afforded the same protection as life insurance proceeds as they are considered to be, like life insurance, an undertaking by an insurer to provide an annuity. As with protected life insurance policies, the RRSP or RRIF must have as its beneficiaries the spouse, child, grandchild and/or parent of the annuitant of the RRSP or RRIF.

By virtue of paragraph 67(1)(b) of the BIA, property that is exempt from execution or seizure under the laws of any province is not considered part of a bankrupt's estate for the purpose of division amongst the bankrupt's creditors. This exclusion would apply to the proceeds of life insurance and RRSPs and RRIFs issued by insurance companies.

Further, and effective July 7, 2008, property in a RRSP or a RRIF issued by any person (not just by an insurance company) is excluded from a bankrupt's estate, and not divisible amongst the bankrupt's creditors, except for property contributed to any such plan in the 12 months immediately prior to the date of bankruptcy.[3]

Asset Protection Planning Using Trusts

Transfer of Assets to a Domestic Inter Vivos Trust

An individual who is or may be exposed to liabilities and third party claims may also, where appropriate, consider transferring assets to a trust, the beneficiaries of which might include members of his or her family who are not otherwise exposed or likely to be exposed to significant creditor liabilities and claims. As with transfers to family members directly, (i) the transfer to the trust must be absolute, (ii) gifts and transfers of property at undervalue may be attacked under the APA, FCA and BIA as described in Part 1 of this article, and (iii) transfers of property to a trust for fair market value may generally not be attacked where they are otherwise made in good faith, however, the subsequent forgiveness of a balance of purchase price payable may be attacked.

An individual gifting or transferring property to a trust must also consider the attribution rules in subsection 74.3(1) of the ITA. Generally, gifts and transfers of property at less than fair market value to a trust that has a "designated person" as a beneficiary (that is a spouse, common-law partner, or minor child, niece or nephew under 18 years old of the settlor or transferor) results in the attribution to the settlor or transferor of income and gains, in the case of income from property and capital gains distributed to a spouse or common-law partner, or income from property, in the case of income from property distributed to a minor child, niece or nephew. Attribution can be avoided by distributing income and capital gains to those beneficiaries who are not a spouse, a common-law partner, or a minor child, niece or nephew of the settlor or transferor of property to the trust. As a trust is deemed to be an individual for Canadian income tax purposes, income earned by a trust which is not distributed to its beneficiaries is subject to tax at the top marginal rate for individuals.

The attribution to the settlor or transferor of income (including capital gains) arising from property contributed to a trust may be an acceptable result where the transfer of property to a trust otherwise achieves the goal of protecting the transferred assets from the settlor's or transferor's creditors.

The capital property and depreciable property held by a trust are deemed to be disposed of 21 years after the settlement of the trust, with the resulting capital gains and recapture taxed at the highest marginal rate for individuals at the time.[4] The tax (and interest) can be paid over 10 years.[5] Capital property, can, however, be transferred to the capital beneficiaries of the trust at any time before the expiry of this 21 year period on a tax deferred or rollover basis.[6]

As with gifts to individuals, gifts of property to a trust are deemed to take place at fair market value and may trigger capital gains or recapture where the gifted asset is non-cash property.[7] Accordingly, it may be preferable to gift cash to a trust, or property which has no unrealized capital gain associated with it.

Further, if an individual does not deal at arm's length with a trust, a sale by the individual of property to the trust at a price that is less than its fair market value is deemed to give rise to proceeds of disposition equal to the fair market value of the property.[8] An individual is deemed under paragraph 251(1)(b) of the ITA not to deal at arm's length with a personal trust[9] in which the individual, or any person not dealing at arm's length with the individual, would be "beneficially interested" in certain circumstances set out in subsection 248(25) of the ITA. Under these circumstances, an individual would be deemed to be beneficially interested in a personal trust if the individual might become a beneficiary of the trust at a later time by virtue of the exercise of any discretion under the terms of the trust.

An individual may not otherwise deal with a trust at arm's length under paragraph 251(1)(c) as a matter of fact, for example where the individual transferor is also the sole trustee of the trust.

In addition to income taxes arising out of the transfer of non-cash property to a trust, there are other taxes, fees and charges, such as land transfer tax, which may be applicable and which should be considered prior to the transfer.

Where a trust is settled for asset protection purposes, the trustees of the trust should not include the transferor in order avoid a court finding that the transferor/settlor continues to own or control the gifted or transferred assets after their transfer to the trust. The transferor/settlor should not be a capital beneficiary of the trust, and should not have the power to determine the beneficiaries of the trust, nor to distribute the capital of the trust, not only to avoid the attachment of his or her interest by creditors but also to avoid attribution arising under subsection 75(2) of the ITA.

Trust deeds often contain protective or spendthrift provisions which provide that, (i) a beneficiary will cease to have an interest in the trust (or cease to have a right to distributions from the trust) upon his or her bankruptcy or insolvency, or upon the attempted alienation of his or her interest in the trust, or (ii) where a beneficiary is merely prevented from transferring his income or capital interest in the trust to a third party. Alternatively, a discretionary trust may accomplish the same purpose, by providing that the trustees have the complete discretion to allocate and distribute the income and capital of the trust to one or more of the potential beneficiaries of the trust to the exclusion of one or more other beneficiaries of the trust. The trustees may simply decline to exercise their discretion to distribute income or capital of the trust to a bankrupt, insolvent, or nearly-insolvent beneficiary.

Rollover Available to Special-Purpose Trusts

The ITA contains exceptions to the above rules and permits rollovers of non-cash capital property to certain special-purpose trusts, including spousal trusts, alter ego trusts, and joint-spousal trusts. In order to qualify for the rollover, the trust must qualify as one of the special-purpose trusts (which may make this kind of trust less desirable or undesirable for the particular asset protection requirements of the proposed transferor), and must otherwise satisfy the conditions in the ITA for the rollover.

A rollover is available in certain circumstances under subsection 73(1) of the ITA for the transfer of capital property to an inter vivos spousal trust. In order for the rollover to apply, the spouse or common-law partner of the settlor must be entitled to receive all of the income and capital of the trust that arises before the death of the spouse. Accordingly, the spouse may be the sole income beneficiary of the trust during the spouse's lifetime (and not a capital beneficiary) and other individuals may be entitled to receive the capital of the trust after the spouse's death. As with transfers to a spouse directly, the rollover to a spousal trust under subsection 73(1) is automatic. However, subsection 73(1) permits the settlor to elect, in his or her tax return for the year of the transfer, that the rollover not apply. A settlor may wish to make such an election where he or she has an available capital gains exemption, loss-carryforwards, or unused tax credits.

In contrast to an alter ego trust, there is no minimum age requirement for the settlor of a spousal trust.

As with transfers of property to family member generally, a settlor must consider his or her relationship with his or her spouse when considering a spousal trust as an asset protection vehicle. A transfer of non-cash property to a spousal trust may be more attractive than an outright transfer of property to a spouse, since it is possible for a spousal trust to provide that a spouse is entitled to all of the income of the trust, but none of the capital, during his or her lifetime as long as no other individual is entitled to receive the capital of the trust during the spouse's lifetime.

Under paragraph 104(4)(a) of the ITA, the 21-year deemed disposition rule does not occur for a spousal trust until the death of the settlor's spouse. However, if the spouse dies within 21 years of the settlement of the trust, the deemed disposition of property under paragraph 104(4)(a) will occur earlier than it would otherwise occur for a trust that is not a special-purpose trust.

Capital property may also be transferred to an "alter ego trust" on a tax-deferred or rollover basis under subsection 73(1) of the ITA. An "alter ego trust" is defined in subsection 248(1) of the ITA. For a trust to qualify as an alter ego trust, the settlor must be at least 65 years of age at the time trust is created, the settlor must be entitled to receive all of the income (and gains) of the trust that arise before his or her death, and no person other than the settlor may receive or use any of the capital of the trust while the settlor is living. Asset protection in respect of the capital of the trust (but not the income) can be achieved by providing that the settlor is not entitled to any capital of the trust during his or her lifetime, and that the capital of the trust be distributed to the beneficiaries of the trust (other than the settlor) after the settlor's death.

Again, subsection 73(1) permits the settlor to elect, in his or her tax return for the year of the transfer, that the rollover not apply.

Pursuant to subsection 104(4) of the ITA the normal 21-year deemed disposition is postponed (or accelerated) for an alter ego trust until the death of the settlor. An alter ego trust may distribute property with an accrued capital gain to the settlor prior to his or her death and on a rollover basis under subsection 107(2) of the ITA.[10] A trust may make an election under subparagraph 104(4)(a)(ii.1) not to have the potential deferral of the 21-year deemed disposition that would otherwise apply to an alter ego trust apply.

Provided that the settlor is not entitled to the capital of the trust during his or her lifetime will also avoid the attribution rule in subsection 75(2) of the ITA where the settlor does not otherwise have the power to determine the beneficiaries of the trust nor to distribute the capital of the trust. If the attribution rule does not apply, the income or capital gains earned or realized by the trust will be taxed in the trust at the highest individual marginal rate then applicable, except to the extent that the income or capital gains are paid or made payable to the settlor in the year and deducted by the trust.

Where an individual is 65 years or older, he or she may also achieve some asset protection by rolling over capital property with an accrued gain to a joint spousal or common-law partner trust and under subsection 73(1) of the ITA. For a trust to qualify as a joint spousal trust, the settlor and his or her spouse must be entitled to receive all of the income (including gains) and capital of the trust that arise prior to the death of the last to die of the settlor and the spouse. However, the settlor's spouse may (to the exclusion of the settlor) be entitled to the capital of trust until the last to die of the settlor and his or her spouse. Again, the settlor of a joint spousal trust may elect under subsection 73(1) not to have the rollover apply.

In addition to achieving some asset protection in respect of the capital of the trust, the exclusion of the settlor as a capital beneficiary of the trust will also avoid the attribution rule in subsection 75(2) of the ITA where the settlor does not otherwise have the power to determine the beneficiaries of the trust, nor to distribute the capital of the trust. However, income and capital gains that are allocated by the trust to the settlor's spouse will be deemed to be income or capital gains of the settlor.

Pursuant to subsection 104(4) of the ITA, the normal 21-year deemed disposition of trust assets is postponed (or accelerated) for joint spousal trusts until the death of both the settlor and the settlor's spouse. A joint spousal trust may distribute property with an accrued gain to the settlor or to the settlor's spouse on a rollover basis prior to his or her death and under subsection 107(2) of the ITA. If the joint spousal trust continues to exist after the death of the settlor, a rollover should then be available to the beneficiaries of the trust.

The considerations which apply under the FCA, APA and BIA to gifts and transfers at undervalue to an inter vivos trust would also apply to gifts and transfers at undervalue to a special-purpose trust. As with inter vivos trusts, the settlor should avoid being a trustee of a special-purpose trust where it is settled for asset protection purposes.

Transfer of Assets to an Offshore Inter Vivos Trust

There are numerous jurisdictions in the world which have legislation which imposes limitation periods on creditors attempting to attack fraudulent conveyances in those jurisdictions. These jurisdictions include the Cook Islands, Nevis, St. Lucia, St. Vincent and the Grenadines, the Bahamas, Belize, Cyprus, Mauritius, the Seychelles, Barbados, Bermuda and the Cayman Islands. With respect to transfers of property to a trust, the limitation periods range from immediately (Belize), that is a creditor is precluded from attacking the transfer to a trust immediately upon the transfer, to two years (Bahamas, Cyprus and Mauritius) to six years (the Cayman Islands).

Accordingly, it may be desirable to consider settling an offshore trust to take advantage of these limitation periods. Having said this, the non-resident trust rules in the ITA generally result in there being no tax advantage to using an offshore trust, even where the trust is resident in and the assets of the trust are situated in a jurisdiction with asset protection legislation and low income tax rates.

Generally, an offshore trust is a discretionary trust, with a class of family and possible charitable beneficiaries.

Under the ITA, a trust is taxed in the same manner as an individual and generally on the basis of its residence. The residence of a trust is generally determined by the place where the central management and control of the trust is exercised, which may or may not be the place of residence of a majority of the trustees of the trust.[11]

However, where the residence of an offshore asset protection trust would otherwise be in a foreign jurisdiction because the trustees of the trust, or a majority of them, are residents in that foreign jurisdiction, section 94 of the ITA will deem the trust to be resident in Canada for tax purposes if a person resident in Canada has transferred or loaned property to a non-resident trust that has one or more beneficiaries that are resident in Canada.

In the case of a discretionary trust, section 94 deems the taxable income of the trust to be the total of its Canadian source income and its foreign accrual property income, if any. Each beneficiary is jointly and severely liable to pay the Canadian tax of the trust. However, the liability can be forced against a particular beneficiary only to the extent that the beneficiary has received a distribution from the trust or proceeds from the sale of an interest in the trust.

Proposed amendments to section 94 of the ITA will deem an otherwise non-resident trust to be resident in Canada where a Canadian resident contributes property to the non-resident trust. Among other things, the contributor, the non-resident trust and certain Canadian resident beneficiaries of the trust may all become jointly and severally liable to pay Canadian tax on the worldwide income of the trust.

As with inter vivos domestic trusts, the settlor should not have a vested interest or right to the income or capital of the trust which could be attacked by creditors, and should not be a trustee of the trust.

As a settlement and contribution of property to a trust involves a complete relinquishment of control over the property settled on or contributed to the trust, it is common for the settlor to identify a non-resident protector with a power to appoint or remove trustees, as well as other trust oversight roles.

If the settlor of an offshore asset protection trust is a trustee of the trust or has revocation power over the trust and its property, or has the power to remove or appoint trustees of the trust, a domestic court may in certain circumstances order the settlor to revoke the trust or to remove a foreign trustee and replace him or her with a domestic trustee over which the court has jurisdiction. It is also possible that a domestic court could similarly order a settlor who has the power to remove/appoint a protector (and where the protector can remove/appoint trustees) to appoint a protector designated by the court who could similarly substitute a domestic trustee selected by the court for a foreign trustee.

The trust deed for an offshore trust should provide that the trust is governed by the laws of the local jurisdiction. And it is more effective for asset protection purposes, and may be required under the local asset protection legislation, that the assets of the trust be situated in the local jurisdiction.

If the assets of the trust remain in Canada, a court might permit the execution of judgment against the Canadian situs assets of the otherwise non-resident trust, notwithstanding that it is expressly governed by the laws of a foreign jurisdiction.

It is common for the trustee(s) of an offshore trust to include for a fee a local jurisdiction trust institution or local resident individuals, often lawyers, to act as a professional trustee(s) of the offshore trust.

Asset Protection Planning for Corporations and Their Shareholders

Generally, businesses are commenced with a single operating corporation and a simple, common share structure, and no holding corporation.

However, as with individuals, consideration should be given to organizing the business and assets of a corporation in such a manner and from the outset (or from the outset of a new venture or a significant financing event) so that the exposure of the business and assets of the corporation to creditors and third party claimants is limited. In addition, consideration should be given to using share conditions which change in certain respects upon any person (including a creditor) other than the original subscriber or holder owning the shares, thus making the shares less valuable, and less attractive to a subsequent owner, including a creditor.

Use of a Holding Corporation

The inter-position of a holding corporation between one or more individual shareholders and an operating corporation may facilitate the removal of the corporation's after tax profits on an annual or more frequent basis by way of a tax free inter-corporate dividend.

The holding corporation may loan all or a portion of the dividend surplus back to the operating corporation if this surplus is required by the operating corporation to run its day-to-day business.

A third party lender (generally a bank) will usually require that the holding corportation guarantee the operating corporation's debts to the lender, and grant a first ranking security interest in the holding corporation's assets to the lender, and subordinate to the lender the holding corporation's security in the pledged or mortgaged assets of the operating corporation.

However, the holding corporation will continue to hold a prior ranking security interest in the operating corporation's assets to secure the holding corporation's advances to the operating corporation, and ranking prior to the claims of subsequent ranking third party secured creditors and all other unsecured creditors except those unsecured creditors who might have a statutory super priority.

These actions will result in the removal of the after tax income of the corporation, which would otherwise be retained earnings of the corporation, and limits exposure to creditors. One must keep in mind the limitations on a corporation paying dividends in a manner prohibited by the *Business Corporations Act* (Ontario), the *Canada Business Corporations Act*, and the BIA.

One or more individual shareholders may transfer on a tax-deferred basis their shares in an operating corporation to a holding corporation under subsection 85(1) of the ITA where there is an accrued gain in the shares of the operating corporation.

An individual could receive on the rollover preference shares of the holding corporation which are non-voting and which could be retractable only in the hands of the original holder, but which otherwise meet the requirements of subsection 85(1). The loss of the retraction feature upon the transfer of the shares to a person other than the original holder would make the preference shares less attractive to a creditor or a trustee in bankruptcy.

A shareholders' agreement might also restrict the redemption or purchaser cancellation of the preference shares without the unanimous consent of all the shareholders of the corporation. Other members of the individual's family, or a trust for other members of the individual's family, might subscribe for the common shares of the holding corporation for nominal consideration, thus protecting the future growth in value of the holding corporation from the claims of third party creditors of the individual transferor.

As an alternative, the holding corporation might exchange its shares of the operating corporation under section 86 of the ITA for fixed value preference shares of the operating corporation. The removal of after-tax profits of the operating corporation could be accomplished by giving the new preference shares a right to a non-cumulative dividend equal to the annual after tax profits of the operating corporation.

By leaving shares of the holding corporation in the hands of individuals, these individuals can later access the capital gains exemption upon the subsequent disposition of the shares of the holding corporation and where the holding corporation's shares appreciate in value and otherwise qualify as small business corporation shares at the time of the ultimate sale of the shares. Consideration must be given to the attribution rules in the ITA discussed above.

In order to access the capital gains exemption on a subsequent sale of shares of the holding corporation, the holding corporation must continue to invest at least 90% of its assets in shares or indebtedness of one or more other small business corporations, and the ultimate purchaser must be willing to purchase the shares of the holding corporation, rather than the operating corporation, or willing to allow the shareholders/vendors to amalgamate the holding corporation and the operating corporation prior to the sale. In such a case the operating corporation must otherwise meet the 24 month 50% "good" asset test and 90% "good" asset test on the date of sale as required by the definition of a "qualified small business corporation share" in subsection 110.6(1) of the ITA.

Segregating Businesses and Assets with Different Risks

Different businesses, and certainly different assets, may have different risks associated with them. Where businesses (or divisions) and assets have substantially different risks associated with them, one should consider segregating the businesses (or divisions) and assets into separate corporations. This would apply to substantial individual capital properties (such as real property and large equipment) and eligible capital properties, such as trade marks, copyrights, and patents, which are used in an operating business, or businesses or divisions of businesses which, due to the nature of their activities, have substantially different exposure to lenders, creditors generally and to third party claimants.

Businesses and both operating and non-operating assets owned by an operating corporation can generally be transferred on a tax-deferred basis to one or more other corporations under subsection 85(1) of the ITA and the rules in section 55 of the ITA and where there is no sale of the shares of the corporation to an arm's length third party purchaser contemplated. One must be aware of the rules in section 22 of the ITA regarding the transfer of accounts receivable, the application of HST to the various classes of transferred assets, and land transfer tax in respect of the transfer of real property.

In most cases where the purpose of the transaction is to affect an internal reorganization of the business and assets of the operating corporation amongst related parties and not in contemplation of an arm's length third party sale, the transfers of assets may take place on a tax-deferred or exempted basis.

Operating assets (including real property) which are transferred to a sister or subsidiary corporation may be leased or licensed back to the operating corporation on a commercially reasonable, and where applicable HST exigible, basis.

Where an operating corporation transfers real property used in its business to another corporation, and leases the property back, rent paid by the operating corporation to the other corporation is deemed to be active business income where the corporations are associated with each other. If the corporations are not associated with each other, the rent received by the corporation owning the real estate will be income from a specified investment business or may be income from property, and will increase the corporation's refundable dividend tax on hand. This will be preferable where the operating corporation otherwise has active business income in excess of a small business limit, currently $500,000 annually.

Protecting Future Growth from Creditors – Estate Freeze

As mentioned with the shares of a holding corporation, the shares of an operating corporation can be reorganized in such a manner so as to shift the future growth in the value of the shares of the operating corporation to other family members who are not exposed to creditors or third party claims. Such a transfer might be accomplished by the transferor exchanging his or her shares under section 86 of the ITA for fixed value and non-voting preference shares which are retractable only in the hands of the transferor. Again, the other members of the transferor's family, or a trust for those individuals, could subscribe for newly issued common shares of the operating corporation for nominal consideration.

The corporation might also issue to the transferor a separate class of strictly voting but non-participating preference shares in order to keep control of the corporation in his or her hands. The Canada Revenue Agency has indicated that it will treat such shares as having nominal value where they are issued for nominal value in the course of a reorganization carried out for estate planning purposes.

Recall that a gift of property to a child who is a spouse will be excluded from that spouse's net family property where the gift occurs after the marriage. Income and any gains from the property will also be excluded when expressly excluded in the deed of gift. Accordingly, it may be advantageous for a parent or grandparent who has no creditors to subscribe for the new common shares for nominal consideration in the first instance, then to gift them to the desired children/spouses.

Notes:

1 See paragraph 69(1)(c) of the ITA.

2 See paragraphs 73(1.01)(a) and (b) of the ITA.

3 See paragraph 67(1)(b.3) of the BIA.

4 See subsections 104(4) and (5) of the ITA.

5 See subsection 159(6.1) of the ITA.

6 See subsection 107(2) of the ITA.

7 See section 69 of the ITA.

8 See subparagraph 69(1)(b)(i) of the ITA.

9 A personal trust is defined in subsection 248(1) of the ITA as inter vivos trust no beneficial interest in which was acquired for consideration payable directly or indirectly to the trust or any person or partnership that has made a contribution to the trust.

10 See paragraph 107(4)(a)(ii) of the ITA.

11 *St. Michael Trust Corp. v. The Queen*, 2009 DTC 450 (TCC); aff'd 2010 FCA 309 (FCA).

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We are a strategically placed, mid-sized law firm – large enough to offer a full range of legal services, yet small enough to be flexible and responsive to our clients' individual needs. Our team of lawyers provides expert advice and legal services in corporate, commercial, real estate, tax, litigation and health law areas.

We are proud to represent some of Canada's largest banks and financial institutions, and several medium to large-sized municipalities.We counsel agencies, boards and commissions and other government entities, high tech and software companies, real estate developers, lenders and investors and Ontario's health care professionals and providers.

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