The Corporate Freeze

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> L'homme moderne tient plus à ses biens qu'à sa vie même, car ses biens sont sa vie d'abord, puis la vie de sa femme, de ses enfants, de sa postérité. (Lamartine *circa* 1830)

Lamartine may have been going too far, but assets are important. Their accumulation is difficult and requires skill. Their protection against erosion is equally difficult. One of the most constant eroding agents is the tax collector who insists on his pound of flesh, not only out of the taxpayer's income while he is alive but also out of his property as it passes to future generations. The taxpayer has the right to apply as much ingenuity in counteracting that agent as he did in accumulating his property. His liability for tax and hence the collector's right to levy it, is determined by statutes which specifically set out the circumstances in which he must pay. If those circumstances do not exist — and taxing statutes must be interpreted litterally [1] — then the taxpayer is not liable. If he has avoided the circumstances legally, he needn't fear a penalty. This principle has long been recognized by the leading tribunals. It has been said that:

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the commissioners of inland revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[2]
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> No man in this country is under the smallest obligation, moral or other so to arrange his legal relations to his business or to his property as to enable the inland revenue to put the largest possible shovel into his stores. The inland and revenue is not slow — and quite rightly — to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the revenue.[3]

There are many techniques available to the taxpayer to minimize the impact of taxation. This article will deal with one of them — the holding company. It will outline how the company may be used to minimize death duties and to facilitate the administration of one's property after death.

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* Of the Bar of Montreal.

1 *Fasken Estate* v. *M.N.R.* [1948] C.T.C. 265 at p. 275-6.

2 *The Duke of Westminster* v. *C.I.R.* [1936] A.C. 1.

3 *Ayrshire* v. *C.I.R.* 14 T.C. 754.

The Quebec-domiciled decedent has to cope with two sets of death duties, namely, Quebec succession duties and the federal estate tax. Death duties are based on the value of the deceased's assets.[4] The higher the value, the higher the duties. One of the keys to successful planning is to freeze one's assets at a maximum value and divert growth from the taxable estate. The freeze, having "set" the value, permits the taxpayer to determine the death duties to be supported by his heirs. He can accordingly arrange for appropriate liquidity at death, which will permit the immediate release of his assets. This is where the holding company can be of great help. It will often appear on the scene in the case of the owner of a prospering company whose growth is reasonably assured. His assets, plus the fact that he will be employed with his company as long as he wishes, give him the assurance that he will be in a constant position to maintain his standard of living. In other words, he's happy with that he's got. Any increase in the value of his assets will only benefit the tax collector by giving him more money. The technique this person ("Mr. B") will apply in setting up his holding company will be the following. Assume here that his business is called Growth Enterprises Inc. and that he owns 100% of its stock worth $500,000.

Step 1. He will incorporate a holding company, say, Holdings Inc., with an authorized capital of at least $500,000 divided into 199,000 Class "A" preferred shares of the par value of $1 each, 300,000 Class "B" preferred shares of the par value of $1 each and 1,000 common shares of the par value of $1 each. Both classes of preferred shares will carry a fixed, non-cumulative dividend rate, will be redeemable at par and will entitle the holders thereof to the return of their capital on liquidation and to no more. The common shares will naturally be fully participating in the company's profits and assets, subject only to the prior rights of the preferred shareholders. Both the Class "A" preferred and the common shares will entitle the holders thereof to one vote per share. The Class "B" preferred will be non-voting.

Step 2. Mr. B will sell all of his Growth Enterprises stock to Holdings Inc. for $500,000 and will be paid by the issuance to him of the preferred and common shares described in Step 1.

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[4] "An estate tax shall be paid as hereinafter required upon the aggregate taxable value of all property passing on the death..." (*Estate Tax Act*, 2(1)).

"All property, moveable or immoveable, the ownership, usufruct or enjoyment whereof is transmitted owing to death, shall be liable to duties calculated upon the aggregate value of the property transmitted..." (*Quebec Succession Duties Act*, 2).

Step 3. Mr. B will then sell or give the common shares of Holdings Inc. to members of his family or business successors.

As a result of this reorganization:

A. Growth Enterprises Inc. will be wholly-owned by Holdings Inc. and hence frozen in Mr. B's estate at a maximum amount of $499,000, being the value of the preferred shares of Holdings Inc. This follows from the conditions of the preferred shares which do not permit participation in the company's profits and assets beyond a fixed dividend rate and a return of capital on redemption or liquidation. Consequently, Mr. B now knows that Growth Enterprises Inc. will not attract death duties on more than $499,000.

B. All of Growth Enterprises' growth has been diverted to the common shares of Holdings Inc. This is tied in with A and follows from the fact that the growth accrues to Holdings Inc. and can be reflected only in its own common shares since the preferred cannot increase in value. If, for example, Growth Enterprises is worth, say, $1,300,000 on Mr. B's death 20 years after the reorganization (a growth of about 5% per annum), Holdings Inc. would be worth the same amount and the shares of Holdings would be worth:

Class "A" preferred:	$199,000
Class "B" preferred:	$300,000
Common:	$801,000

There will be no gift tax on the transfer of the common shares, because they will have been sold for real value ($1,000) or, if given, should be within Mr. B's gift tax exemption.[5] If sold for real value, they will not attract death duties. If given, they will attract Quebec succession duties if Mr. B dies within 5 years of the gift and federal

[5] "For the purposes of this Part, "aggregate taxable value" is the aggregate value of the gifts made by the donor during the taxation year other than those exempt under subsection (3) or (4) minus

(a) in the case of an individual, either

(i) $4,000, or

(ii) one-half the difference between the taxable income of the donor for the immediately preceding taxation year as determined under Part I and the tax that was payable thereon under Part 1,

whichever is greater..."

"Where the value of all gifts made by a donor to an individual in a taxation year does not exceed $1,000, those gifts are exempt from tax under this Part." (Income Tax Act, 12(2)(3)).

estate tax if he dies within 3 years.[6] In either case, the duties will be on the real value of the shares given at the date of death.

C. Mr. B will continue to control Growth Enterprises as long as he wishes. This follows from his control of Holdings Inc. (199,000 votes against 1,000) which in turn controls Growth Enterprises.

D. Having so "set" the value of Growth Enterprises, Mr. B can embark upon an effective estate reduction program. He has already disposed of the growth so he need not be concerned that the value of what he keeps will increase faster than what he gives away. He will carry out his program by first giving away his non-voting Class "B" preferred shares within the maximum limits of his gift tax exemptions and deductions. When this is complete he will have given away $300,000. He can then start giving the Class "A" voting shares. If he does not yet wish to distort his percentage of votes, he can convert part of the "A" into non-voting "B" and restrict his gifts to that class.

E. If Mr. B does not wish to reduce the value of his estate, as will often happen if he wants to assure that his widow will have a sufficient income after his death, the division of the equity into voting and non-voting preferred affords him the opportunity of allowing control to be exercised by business associates or key employees without interference by his widow. By the same token, his widow will be fully protected in that she will benefit from the income of the non-voting stock. He can provide for this in his will by bequeathing the voting stock in trust to a group of key employees or business associates and the equity or Class "B" preferred stock to trustees for the benefit of his widow. The widow will be protected by stipulations in the will to the effect that the trustees holding the voting

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[6] "There shall be included in computing the aggregate net value of the property passing on the death of a person the value of...

(a) ...

(b) ...

(c) property disposed of by the deceased under a disposition operating or purporting to operate as an immediate gift *inter vivos*, whether by transfer, delivery, declaration of trust or otherwise, made within three years prior to his death."

(Estate Tax Act, 3(1)*).*

"For the purposes of this act, the ownership, usufruct or enjoyment of any property shall be deemed to be transmitted owing to death:

(1) Whenever the deceased has disposed thereof by gratuitous title in any manner whatsoever and the said disposition has taken effect within the five years prior to the death of the person by whom it was made." *(Quebec Succession Duties Act,* 22(1)*).*

stock must vote their shares each year in order to pay out so much money on the Class "B" shares by way of dividend and/or redemption. This money would then be remitted to his widow by the trustees of the "B" stock.

F. Holdings Inc. can also be used to provide tax-free funds at death to pay death duties. This aspect of the reorganization is tied in with the notion of designated surplus, Section 138A of the Income Tax Act, and Holdings Inc.'s "personality" within the meaning of that Act. It is a rather tricky and dangerous sport and will be dealt with later in this article.

The three steps of the holding company reorganization are simple — and the results rewarding. However, as in all else, there is a right way to do things — and a wrong way. As one of the key players on the estate planning team, the lawyer should make sure the right way is chosen. There exist several obstacles (more or less hidden) which could destroy the usefulness of the holding company. They will now be reviewed as they appear at each step of the way.

STEP 1

The choice of a federal or provincial charter. The right to vote cannot be completely removed from preferred shares of a federal company (a usual provision is that preferred shares acquire voting rights if dividends thereon are not paid for two consecutive years). It can in the case of Quebec companies. Accordingly, if non-voting preferred shares are contemplated for the reasons outlined below, a Quebec charter should be chosen.

The preferred shares. The conditions attached to the preferred shares should clearly limit the holders' participation to a fixed dividend rate and to return of capital only. They should have no further rights to participate in profits and assets of the company. If no such limitation exists, the preferred stock will share the growth of the company with the common and will not have frozen values. Furthermore, it has been recently held that a controlling "preferred" shareholder whose "preferred" shares entitled him to quasi-unlimited dividends was competent to dispose of the assets of the company within the meaning of the Estate Tax Act and that his estate was liable for death duties on those assets.[7] Although the circumstances of that case are rather unique, it has caused some commotion and a

[7] *Barber* v. *M.N.R.* [1966] D.T.C. 315.

short review of it appears justified. The facts are that in 1946, Mr. Barber incorporated a holding company with an authorized capital of $50,000 divided into 500 Class "A" shares and 4,500 Class "B" shares of the par value of $10 each. The conditions attached to the Class "A" and Class "B" shares can be summarized as follows:

— The Class "A" shares were entitled to a fixed, cumulative, preferential dividend of 5% per annum and, on liquidation, to the balance of the company's assets after distribution to the Class "B" shareholders.

— The Class "B" shareholders were entitled to all the net earnings, profits or income of the company declared as dividends after the payment of the 5% dividend on the Class "A" and, on liquidation, were entitled to receive the par value of their shares and no more.

— Both classes were entitled to one vote per share.

Between the date of incorporation and Barber's death, Barber transferred securities to the company in exchange for Class "A" and Class "B" shares of its capital stock. At the date of death, the net asset value of the company was $146,654, and its shares were owned as follows:

— Mrs. Barber: 1 Class "A"

— Mr. Barber: 4,497 Class "B"

The three other "B" shares beneficially owned by Barber were registered in the names of the directors for qualifying purposes.

Barber's executors included the Class "B" shares in his estate at their par value of $45,000. The Minister of National Revenue increased the taxable estate by $101,610, being the surplus in the company after allowing $10 for the one outstanding Class "A" share. He alleged that the additional amount was taxable because Barber was competent to dispose of it immediately before death.[8]

The assessment was objected to but the Tax Appeal Board ruled in favour of the Minister. The reasons given were:

— Barber controlled the company and could have withdrawn the entire surplus by way of dividends on the Class "B" shares;

— he was free to change any of the provisions governing the capital stock;

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[8] "There shall be included in computing the aggregate net value of the property passing on death...

(a) all property of which the deceased was, immediately before his death, competent to dispose..."

(Estate Tax Act, 3(1) (a)*).*

— his competency to dispose of the company's assets was accentuated by the fact that he and his wife were its two beneficial shareholders.

It is the writer's view that Mr. Barber's Class "B" shares as a block were worth $146,610, because they controlled the company and had the right to quasi full participation in the company's profits. The interesting feature of the case is the Minister's approach. The judgment would have attracted very little attention if the increased tax had been levied on the basis of the real value of the shares. Instead, the Minister chose to look upon the assets of the company as property which the deceased could freely dispose of. One has to agree that the share conditions gave Mr. Barber the right to freely withdraw the company's surplus. On the other hand, the judgment does not provide authority for the proposition that the controlling shareholder of a company has the power to dispose of the company's assets. He must respect the rights of minority shareholders. It is an accepted principle that majority shareholders cannot take unfair advantage of the minority, whose rights in such instances are protected by the courts. It is not within the power of the majority to sacrifice the interests of the minority to serve its own selfish ends. This principle requiring fair if not equality of treatment has been applied in distribution of company property among shareholders where there has been an attempt on the part of one group to benefit themselves at the expense of others and to use their majority powers for that purpose. Wegenast states at page 321 of his treatise on company law:

> It is not open to the majority to divide the assets of a company among themselves to the exclusion of minority or to make presents to themselves of company property.[9]

Admittedly, these principles do not apply in Barber's case since the "B" shares clearly gave their holders the right to participate in surplus. The exercise of that right cannot be considered as legally unjust to shareholders of another class who are presumably aware of it when they acquire their shares. This is not a question of the majority sacrificing the interests of the minority for selfish purposes such as acquiring a corporate asset for less than its real value. It is merely a question of the majority exercising its rights in accordance with the conditions of its shares. The fact that the only other shareholder involved in Barber was Mrs. Barber, who held one out of 5,000 shares, pushes minority rights further into the background. Indeed, this might very well be what the assistant chairman of the Tax Appeal Board had in mind when he said: "If there had been

[9] Wegenast, *Canadian Companies*, p. 321. See also p. 315 *et seq.* Also Fraser & Stewart, *Company Law of Canada*, 5th ed., p. 717 *et seq.*

other shareholders for value, with consequent vested interests, such as strangers, for instance, additional factors might have called for consideration, but this was not the factual position."

Of greater interest is the Board's second reason that Mr. Barber was free to change any of the provisions governing the capital stock. This should not have been a consideration. Mr. Barber did not have to change anything on his shares. He had quasi full participation anyway, which is what made his shares valuable. If preferred shares provide for a fixed rate of dividends and limited participation in the corporate assets on distribution, an increase in either reduces the value of the junior or common shareholders' equity rights. It is a recognized rule of law that any change in shareholders' rights must have the approval of the shareholders affected.[10] The required approval, in the case of federal and Quebec companies, will be either unanimity, three-quarters or two-thirds of the shares affected, depending upon the change sought and the provisions of the company's charter and by-laws. Indeed, the company might very well have to go through the procedure of arrangements and compromises with shareholders as set out in the relevant statutes.[11] This procedure, in addition to requiring shareholder approval, necessitates the sanction of a judge prior to an application for supplementary letters patent. Accordingly, one should not conclude from the Barber case that a controlling shareholder can change the conditions of his shares as he so wishes. He cannot disregard the rights of other shareholders.

The conditions attached to the Class "A" and Class "B" preferred shares of Holdings Inc., as indicated above, are clearly distinguishable from those of the late Mr. Barber's company. Hence the Barber decision should not apply.

The preferred shares are divided into two classes (voting and non-voting) to permit reduction of the estate without affecting the planner's voting percentage. As explained in D,[12] he can do this by giving away the non-voting preferred. If it is felt that the non-voting stock will be put into a trust for the benefit of a particular beneficiary, as explained in E, the dividend on the voting preferred should rank after the dividend on the non-voting. An alternative is to have a small number of voting preferred shares at the outset, so that the servicing of their dividend will not be too onerous on the company. This alternative is not to be recommended. A small number of voting preferred shares with very little equity participation can nevertheless be very

[10] Fraser & Stewart, *Company Law of Canada*, p. 328 *et seq.*

[11] Section 46, *Companies Act*; Section 126, *Canada Corporations Act.*

[12] See page 4.

valuable if they control a prospering business. The Tax Department will certainly attempt to assess those shares at a value much higher than par. It is therefore advisable for the controlling preferred shares to represent a reasonable portion of the company's equity.

The dividend rate on the preferred stock should be reasonable in the light of current interest and dividend rates. Rates varying between 6% and 10% have been acceptable to the Department of National Revenue. The non-voting stock should carry a slightly higher rate than the voting.

STEP 2

(Section 23(2). The big obstacle here is Section 23(2) of the Quebec Succession Duties Act.[13] The section taxes any property transferred to a company in exchange for securities of the latter if the transfer is outside the ordinary course of business and has resulted in the avoidance or decrease of succession duties. The property so transferred is taxed on its value at the date of death less the value at the same date of the securities received in exchange.

The key move around this obstacle is to include all of the common shares of Holdings Inc. in the consideration paid to Mr. B. The last paragraph of Section 23(2) provides that the real value of the property to be taxed as at the date of death is that which exceeds the real value as at the same date of what Mr. B received in exchange for the shares transferred to the holding company. Accordingly, if he received the common shares, their value at death must be deducted from the taxable amount. The computation in Mr. B's case would be as follows:

Add property deemed transmitted on death		
Real value of shares of Growth Enterprises at date of death		$1,300,000
Deduct value at same date of property received in exchange		
Class "A" preferred shares of Holdings Inc.	$300,000	
Class "B" preferred shares of Holdings Inc.	199,000	
Common shares of Holdings Inc.	801,000	$1,300,000
Taxable amount		*Nil*

[13] "Whenever a person domiciled in the Province at the time of his death, which occurred after the 1st of January 1950, has assigned or transferred to a partnership, company or corporation any property in consideration of or in exchange for capital shares, bonds, debentures, notes or other securities of such partnership,

On the other hand, if the common shareholders had directly subscribed for their shares and the company issued preferred shares only to Mr. B as consideration, the computation would be as follows:

Add property deemed transmitted on death		
Real value of shares of Growth Enterprises at date of death		$1,300,000
Deduct value at same date of property received in exchange		
Class "A" preferred shares of Holdings Inc.	$300,000	
Class "B" preferred shares of Holdings Inc.	199,000	499,000
Taxable amount		$ 801,000

It is obviously important for all of the documents to clearly indicate that each link of the chain has been solidly welded. Not only should the contract of sale clearly stipulate that the common shares are part of the consideration paid to Mr. B, but the minute book of Holdings Inc. should show their issuance to Mr. B, as should its stock ledger and share certificates. The minutes should then indicate a subsequent transfer to his family, as should both the ledger and the endorsements on the certificates. A short cut there could be deadly.

Gift tax. The other obstacle to watch for is gift tax. If this tax is to be avoided, proper values must be used on the sale of Growth Enterprises' stock to Holdings Inc. The shares must be sold for their real value, neither more nor less. If they are sold for more than their

company or corporation, or for revenues, emoluments, benefits, payments or other advantages, and such assignment or transfer was made otherwise than in the ordinary course of business and has resulted in the avoidance or decrease of the duties which would otherwise have been payable under this act, had such transfer or assignment not been made and such property had formed part of his estate, at the time of his death, the ownership, enjoyment or usufruct of such property shall be deemed, for the purposes of this act, to have been transmitted owing to the death of the assignor or transferor and shall be included in his estate. Every person benefiting therefrom, directly or indirectly, whether in consequence of the said assignment or transfer or of contemporaneous or subsequent deeds or instruments executed by the deceased, shall pay, in proportion to the benefit derived by him, the same duties in respect of the property deemed to have been transmitted owing to the death, as would have been payable, had the ownership, enjoyment or usufruct of the property assigned or transferred been transmitted to him owing to the death of the assignor or transferor.

The real value of the said property, as at the date of the death, shall be determined by the collector having jurisdiction, who shall, however, deduct therefrom, for succession duty purposes, the real value, as at the same date, of the property received in exchange." *(Quebec Succession Duties Act,* 23(2)*)*.

worth, the excess can be considered as a benefit from a company (Holdings Inc.) to a shareholder (Mr. B). These benefits are taxable under the Income Tax Act.[14] If they are sold for less, then the difference between the price and the value is reflected in the common shares. If the difference exceeds Mr. B's gift tax exemption, gift tax will be due on the transfer of common shares to members of his family. Assume, for example, that the real value of the Growth Enterprises stock is $600,000 instead of $500,000. If Mr. B receives $499,000 in preferred shares and $1,000 in common stock as consideration, it follows that the 1,000 common are worth the difference between $499,000 (the value of the preferred) and $600,000, namely, $101,000. If the common are subsequently sold for $1,000, there is a gift of $100,000 which is subject to gift tax.

The real or fair market value of private company shares is not easy to determine. Fair market value has been defined as the price that an item can fetch when sold by a vendor who is not forced to sell to a purchaser who is not forced to buy, both of whom are completely familiar with the item sold and the circumstances affecting it. In other words, it is the price paid by a willing buyer to a willing seller. The problem is accentuated in the case of a private company because there is no public market for its shares. If they were listed on the stock exchange, then their value would be their closing price as at the date of the transaction.[15] There is no such luxury in valuing

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[14] "Where, in a taxation year,

(a) a payment has been made by a corporation to a shareholder otherwise than pursuant to a *bona fide* business transaction,

(b) funds or property of a corporation have been appropriated in any manner whatsoever to, or for the benefit of, a shareholder, or

(c) a benefit or advantage has been conferred on a shareholder by a corporation,

otherwise than

(i) on the reduction of capital, the redemption of shares or the winding-up, discontinuance or reorganization of its business,

(ii) by payment of a stock dividend, or

(iii) by conferring on all holders of common shares in the capital of the corporation a right to buy additional common shares therein,

the amount or value thereof shall be included in computing the income of the shareholder for the year." *(Income Tax Act,* 8(1)*).*

[15] "...the value of any security that is listed on a stock exchange, or, in the case of any security not so listed, on which a price or quotation is obtainable from a recognized financial journal or financial report or from a registered broker, shall be deemed to be the closing price or quotation of that security on the day as of which such value is required to be computed, or, if there was no closing price or quotation on that day, on the last preceding day on which there was a closing price or quotation." *(Estate Tax Act,* 27(1)*).*

private company shares. One must assume a market and estimate a value on that basis. Our courts have long recognized the complexity and elusiveness of determining the proper value of a certain asset at a given time. It has been said that:

> *Value* is a general and indefinite term, and is as variable as the opinions or humours of men. It may be nothing or something very great in the same object, at the same time, in the eyes of different men.[16]

Although the shareholder himself (Mr. B) and his auditor will normally determine the value of the shares, the lawyer involved in estate planning should at least have a general notion of how values can be determined. That subject in itself justifies a thick book. The following are the two basic methods:

1. Book value:- This is simply the result obtained by deducting the company's liabilities from its assets. It is the company's net worth, its shareholders' equity. If the company has only one class of stock, i.e. common, then all of that equity belongs to the common shareholders and is the book value of their shares. If the company has preferred stock, its value must be deducted from the overall book value to determine the value of the common. Take the following balance sheet as an example:

Assets:		Liabilities:	$250,000
	$780,000		
		Shareholders' Equity	
		2,000 pref. at $1	$200,000
		1,000 common at $1	1,000
		Surplus	329,000
	$780,000		$780,000

The book value of the company is $530,000 (the difference between $780,000 and $250,000) and the book value of the common is $330,000, the result obtained by deducting the 2,000 preferred shares from $530,000.

2. Earnings value:- This value is established by capitalizing average past earnings of a company at a given rate. The past earnings considered should cover a period which is representative of the company's profit history. The capitalization ratio should be chosen in the light of the price earnings ratio of companies in similar businesses whose shares are traded on stock exchanges. Say, for example, that the average net after-tax earnings of Growth Enterprises for the last five years have been $55,000. The price earnings ratio of listed companies in similar businesses is 12, in other words, shares of

[16] *Hickey* v. *Stalker* [1924] 1 D.L.R. 440.

similar companies on the public market are selling at 12 times earnings. A substantial discount (say, 25%) can be justified for a private company whose shares are not listed on the public market. This gives a capitalization rate of 9 and a value of $495,000 for the stock of Growth Enterprises on an earnings basis ($55,000 x 9).

Book value does not reflect intangibles such as goodwill. Hence it is often unrealistic and if used must be adjusted to reflect various items. For estate planning purposes, it will normally be accepted by the Department of National Revenue if it exceeds the value based on earnings. If the eanings value is considerably lower than book, it may be possible to have the Tax Department accept a discounted book or "break-up" value. This is predicated on the premise that the value of assets is measured by their production. If they do not produce, they should be disposed of. Break-up value is the amount realized upon the disposal of a "broken" business' assets. It will often be less than book value.

If the earnings value exceeds book, the estate planner will attempt to discount it and arrive at a figure somewhere between the two. The arguments in favour of a discount will be more or less reasonable, depending upon the circumstances in each case. Some of the factors which may be used are:

(i) The one-man business argument, i.e. Growth Enterprises may be worth so much with Mr. B at the helm but would suffer a heavy drop in profits following his death;

(ii) The earnings for a part of the period examined were extraordinarily high;

(iii) Much heavier competition is expected in the near future;

(iv) A good deal or all of the company's profits depend upon licenses or franchises which can be revoked on short notice.

When all of the appropriate factors have been considered, a figure must be chosen. Quite frankly, at this stage the choice is often a guess — the determination of real value is arbitrary. However, if it has been "arbitrarily" chosen after all the above factors and financial *data* have been considered and examined, it will be very close to what the Tax Department would consider as real value. The planner should then submit his value for approval by the Department of National Revenue. This is done by writing the Department, setting out the details of the reorganization, a short outline of the company's operations and financial data in support of the valuation sought. Financial statements covering the periods mentioned in the letter should accompany it. The Tax Department can be slow in processing submissions for valuations. Indeed, some district offices (Montreal, among others) have suspended valuations for estate planning pur-

poses until further notice because of Section 138A of the Income Tax Act.[17] The estate planner need not be delayed for those reasons. He should complete his reorganization by selling his shares to the holding company for a price subject to adjustment in the light of the Tax Department's valuation. The contract of sale between Mr. B and Holdings Inc. can provide that additional preferred shares and/or promissory notes will be issued to Mr. B by the purchasing company to take up the difference, if any, between the value of the shares sold (the shares of Growth Enterprises Inc.) as used in the contract and such higher value as may be determined by the Tax Department and accepted by the parties. This permits the taxpayer to freeze as at a given date regardless of how long it then takes the tax officials to value the shares. Whenever they do get around to valuing them, even if it's only at his death, they must value them as at the date of the transaction, regardless of what has transpired afterwards from the point of view of the company's operations. This formula of an "escalation clause" is acceptable to the tax officials. It is suggested, however, that if used, a copy of the contract be sent to the Department with the submission. A client's first reaction to this type of contract may very well be that he is handing the tax collector the butt of a loaded shotgun. However, that is not so. If the Department comes back with a considerably higher value which is not acceptable to the taxpayer, the latter need not accept it. He will then be assessed for gift tax, can object to the assessment and let real value be determined by the courts. Hence the valuation is not up to the Tax Department. It is also felt that the longer the Tax Department's delay the better for the planner. If a reasonable value is used and submitted to the tax officials with all required data and justifications, it would be awkward for the Department to change that value several years afterwards after having refused to value at the time of the transaction. This is not to say that the Department cannot do it, but it would be difficult. In practice, most valuations seem to be satisfactorily settled for all concerned.

As an added measure of certainty, the taxpayer may, if he so wishes, have the shares valued by an independent expert appraiser, whose valuation isn't as likely to be considered biased. The Department will hesitate to take issue with such an appraisal — especially if the appraiser's services are sometimes sought by the Department itself in valuing shares. The advice of a real estate appraiser should definitely be sought if the company owns substantial real estate.

Finally, if the planner insists upon a Department valuation before going ahead, there exists a slow but rather sure way to finesse the

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[17] See page 18.

Department into making a valuation. The taxpayer should simply give away a few shares of his company and declare it for gift tax purposes. The Department will then have to value the shares given to assess the gift tax. Once this is done, the taxpayer can use the same basis of valuation for the reorganization.

STEP 3

Time lapse. There should be the smallest possible time lapse between Steps 2 and 3 in order to avoid an increase in the value of the common stock. Ideally, Step 3 should be completed the day following Step 2.

Sale or gift. Mr. B can dispose of the shares by way of gift or sale. If proper values have been used, as indicated above, the common shares will be worth only $1,000, which should be easy to finance. A sale is preferable because it immediately extracts the growth from Mr. B's estate. If the shares are given, their value at the date of death will be included in Mr. B's estate for Quebec succession duty purposes if he dies within 5 years of the gift. The same applies for federal estate tax if he dies within 3 years. If the sale is impossible (such as to Mr. B's wife or to his minor children without a tutor duly authorized by the courts),[18] then Mr. B must give. It is suggested, however, that in certain circumstances the estate planner can disregard the civil restrictions on sales to minors. This applies when the minor involved is 17 years of age or over. The reasoning here is that the nullity of a sale to a minor is not absolute but relative. It can be claimed only by the minor or his tutor and only in the case of lesion.[19] It cannot be claimed by the Tax Department. Furthermore, the transaction can no longer be voided if it is ratified by the minor

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[18] "Without the authorization of the judge, or prothonotary, granted on the advice of a family council, the tutor is not allowed to borrow for the minor, nor to alienate or hypothecate his immoveable property; nor is he allowed to make over or transfer any capital sums belonging to the minor, or his shares and interest in any financial, commercial or manufacturing joint-stock company." (Art. 297 C.C.).

"Such authorization can only be granted in cases of necessity or for an evident advantage.

In the case of necessity, the judge or prothonotary grants his authorization only when it is established by a summary account submitted by the tutor, that the moneys, moveable effects and revenues of the minor are insufficient.

In all cases, the authorization indicates what property is to be sold or hypothecated, and any conditions deemed expedient." (Art. 298 C.C.).

[19] Articles 987 and 1002 C.C. Trudel, *Traité de Droit Civil*, Tome 2, pp. 291-314, Tome 7, pp. 81 and 233.

upon his attaining the age of majority. Accordingly, if Mr. B gives to his child of, say, 18 years old, he will have to wait until the child is 23 before the shares are completely exluded from his estate for death duty purposes. On the other hand, if the shares were sold, the child could ratify on attaining 21 and Mr. B would have gained 2 years. If he were to die before his child attains 21, the relative nullity rule makes it highly unlikely that the Tax Department could be successful in an attempt to void the sale. If the child is 16 or under, Mr. B should give. Here, the 5-year maximum limitation will either coincide with (or be less than) the years it will take to reach 21 and ratify. Furthermore, if a sale is made to a child of a young age, the nullity might very well be absolute for lack of legal consent.

Form of gift. The gift should be in notarial form. There are several strong arguments against the gift of private company shares being a "don manuel". The requirement of having the transfer approved by the Board of Directors is the main one. Physical delivery of the share certificate endorsed for transfer cannot be said to complete the gift if a corporate resolution is also required to transfer title.[20]

Acceptance.....It is unnecessary to appoint a tutor to accept a gift to a minor. It can be done by a child's parent or a grandparent.[21] Indeed, the writer feels that a tutor should be avoided if at all possible. The reasoning here is Section 27 of the Quebec Succession Duties Act. That section makes it quite clear that the donee must have complete administration of the asset given to the exclusion of one and all.[22]

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[20] "Deeds containing gifts *inter vivos* must under pain of nullity be executed in notarial form and the original thereof be kept of record. The acceptance must be made in the same form.

Gifts of moveable property, accompanied by delivery may however be made and accepted by private writings, or verbal agreemnts." (Art. 776 C.C.).

Se also *The Object of the Don Manuel* by Watt, 16, *Revue du Droit*, p. 160.

[21] "Gifts made to a minor may be accepted by his tutor, or a tutor *ad hoc*, or by his father, mother, or other ascendants; such acceptance being valid without the advice of any family council." (Art. 303 C.C.).

[22] "For the purposes of this act, the ownership, usufruct or enjoyment of any property shall be deemed to be transmitted owing to death, whenever the deceased has disposed of same by gratuitous title, in any manner whatsoever, by a disposition which has taken effect more than five years prior to the date of death, unless the ownership, possession, usufruct, enjoyment, administration of and the revenue from or the income on the said property has actually been assumed and thenceforward retained by the real beneficiary, to tbe exclusion of the donor or of any other person." *(Quebec Succession Duties Act, 27).*

The main function of the tutor is to administer the minor's assets.[23] Hence, the minor does not have the complete administration required by Section 27. It should be mentioned that the writer's view here is a minority one (at least among the confrères with whom I discussed it). The big argument against this view is that civilly speaking, the tutor is the minor. He is a continuation of his ward's personality. However, estate planning is preventive law and discretion is the better part of valour if it means avoiding death duties on the common shares given to minors. Accordingly, it is suggested that tutors be avoided in the case of giving common shares of holding companies to minors.

Income Tax

Mr. B's reorganization as constituted will not produce immediate income tax benefits. This results from the holding company's character as a personal corporation and the deemed distribution of the latter's income to its shareholders for income tax purposes.[24] Holdings Inc. will be a personal corporation for each of its taxation years

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[23] "A tutor has the care of the person of his pupil, and represents him in all civil acts.

He is bound to manage his property like a prudent administrator, and is liable for the damages which may result from bad management.

He can neither buy the property of his pupil, nor take it on lease, nor accept the transfer of any right or any debt against his pupil." (Art. 290 C.C.).

[24] "The income of a personal corporation whether actually distributed or not shall be deemed to have been distributed to, and received by, the shareholders as a dividend on the last day of each taxation year of the corporation." *(Income Tax Act,* 67(1)*)*.

"In this Act, a "personal corporation" means a corporation that, during the whole of the taxation year in respect of which the expression is being applied,

(a) was controlled, whether through holding a majority of the shares of the corporation or in any other manner whatsoever, by an individual resident in Canada, by such an individual and one or more members of his family who were resident in Canada or by any other person on his or their behalf;

(b) derived at least one-quarter of its income from

(i) ownership of or trading or dealing in bonds, shares, debentures, mortgages, hypothecs, bills, notes or other similar property or an interest therein,

(ii) lending money with or without securities,

(iii) rents, hire of chattels, charterparty fees or remunerations, annuities, royalties, interest or dividends, or

(iv) estates or trusts; and

(c) did not carry on an active financial, commercial or industrial business.

For the purpose of paragraph (a) of subsection (1), the members of an individual's family are his spouse, sons and daughters whether or not they live together." *(Income Tax Act,* 68(1) (2)*)*.

throughout which it will be controlled by Mr. B and will not carry on an active commercial, financial or industrial business. Consequently, so long as both those conditions exist, any dividends the company might receive from its subsidiary, Growth Enterprises, while not taxable in its hands will be taxable to Mr. B whether or not he has actually received them. Until June 13, 1963 and the advent of Section 138A of the Income Tax Act, many estate planners used the holding company technique to minimize income tax in addition to its death duty advantages. They would do so by "depersonalizing" their holding company. This automatically wiped out the deemed distribution of the holding company's income, which was then paid out to the planner tax-free through redemption of the holding company's preferred shares. Depersonalization was achieved by either having the holding company carry on an active business or by allotting less than 51% of its voting shares to the planner and members of his family. For the purpose of a personal corporation, the members of an individual's family are his spouse, sons and daughters, whether or not they live together. Hence, for example, Mr. B could depersonalize Holdings Inc. by transferring 100,000 Class "A" preferred shares to his brother.

The only tax liability attracted by such an arrangement was the taxation of dividends received by the holding company to the extent that they were paid out of the subsidiary's "designated surplus", i.e. its surplus as at the end of its last complete taxation year before its control was acquired.[25] Dividends paid out of the subsidiary's

[25] "Where a corporation in a taxation year received a dividend from a corporation that

(a) was resident in Canada in the year and was not, by virtue of a statutory provision, exempt from tax under this Part for the year,...

an amount equal to the dividend minus any amount deducted under subsection (2) of section 11 in computing the receiving corporation's income may be deducted from the income of that corporation for the year for the purpose of determining its taxable income.

Notwithstanding subsection (1), where

(a) a dividend was paid by a corporation that was resident in Canada and was controlled by the receiving corporation, and

(b) the payer corporation had undistributed income on hand at the end of its last complete taxation year before the control was acquired (which undistributed income is hereinafter referred to as the "designated surplus"),

if the dividend was paid out of designated surplus, no amount is deductible under subsection (1) ...

For the purpose of subsection (2), one corporation is controlled by another corporation if more than 50% of its issued share capital (having full voting rights under all circumstances) belongs to the other corporation or to the other corporation and persons with whom the other corporation does not deal at arm's length." (*Income Tax Act*, 28(1) (2) (3)).

earnings from the commencement of its taxation year in which control was acquired are free of tax.

Although there has been no change in the various sections of the Income Tax Act as to the qualifications of a personal corporation or the tax treatment of intercorporate dividends and the redemption of preferred shares, Section 138A of the Income Tax Act has deterred the estate planner from seeking income tax advantages from his holding company reorganization. The section gives the Minister of National Revenue the right to assess as taxable any amount received as consideration for, among other things, the sale or redemption of shares if in his opinion the transactions were for the purpose of substantially reducing the assets of a company in a way that tax has been or will be avoided on what would otherwise have been a taxable distribution.[26] The purpose of the section was to put an end to surplus stripping operations. Its generality and wide discretionary powers have led to threats by Department of National Revenue officials that it would be used in the case of estate plan holding companies. Their reasoning, in effect, is that the income tax immunity of the subsi-

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[26] "Where a taxpayer has received an amount in a taxation year,

(a) as consideration for the sale or other disposition of any shares of a corporation or of any interest in such shares,

(b) In consequence of a corporation having

(i) redeemed or acquired any of its shares or reduced its capital stock, or

(ii) converted any of its shares into shares of another class or into an obligation of the corporation, or

(c) otherwise, as a payment that would, but for this section, be exempt income,

which amount was received by the taxpayer as part of a transaction effected or to be effected after June 13, 1963 or as part of a series of transactions each of which was or is to be effected after that day, one of the purposes of which, in the opinion of the Minister, was or is to effet a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of iucome of a corporation has been or will be avoided, the amount so received by the taxpayer or such part thereof as may be specified by the Minister shall, if the Minister so directs,

(d) be included in computing the income of the taxpayer for that taxation year, and

(e) in the case of a taxpayer who is an individual, be deemed to have been received by him as a dividend described in paragraph (a) of subsection (1) of section 38."

(Income Tax Act, 138A(1)*).*

diary's dividends as they move into the holding company and through it to the planner's pocket by preferred share redemptions or other payments constitutes the distribution of assets which would otherwise be taxable. Such amount [27] having been received on the sale of the subsidiary's shares or the redemption of preferred stock gives the tax officials what they need to threaten the use of 138A. Although there are several arguments which could be used against its application, such as the fact that a "substantial" reduction of assets at the time of the transaction would require a taxable dividend out of designated surplus, the ministerial discretion looms large and its application should not be invited if at all possible. It is felt that such an invitation does not exist so long as the holding company remains a personal corporation.

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[27] "'Amount' means money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing." *(Income Tax Act,* 139(1)(a)*).*