TAB 15

Will an Estate Freeze Melt Down in Net Family Property Equalization?

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CONTINUING LEGAL EDUCATION

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PART I - ISSUES FOR DISCUSSION

1. There are three issues for discussion:

   (1) Is the value of assets gifted to a child after the date of his or her marriage pursuant to an estate freeze included for purposes of equalization of net family property under Part I of the Family Law Act?

   (2) Will an estate freeze or transfer of assets before marriage or during cohabitation be set aside for purposes of net family property equalization?

   (3) What are some of the factors that should be considered in structuring and papering an estate freeze by corporate reorganization or family trust?

PART II – ANSWERS TO ISSUES - FACTORS AND RECOMMENDATIONS – FORMALITIES, FAIRNESS, BONA FIDES, DOCUMENTARY CARE, AND DISCLOSURE

2. The following is a review of factors and recommendations for planners in the areas of estates and trusts with respect to protecting the exclusion:

   (a) **The form of the transaction and the documents are critical to having the exclusion or estate freeze upheld in family law.**

   (b) **Declarations to Revenue Canada, financial institutions and others are not considered binding in family law at this time. A family law court will assess the transaction on its merits for family law purposes to achieve fairness.**

   (c) In **Karakatsanis v Georgiou, the court held that the shares were not excluded property.** This case **should be distinguished as a pre-1979 transaction** to circumvent that the Gift Tax Act and Succession Duty Act. **The estate freeze in Karakatsanis was set up as a sale for substantial consideration, not a gift. That is why Justice Greer stated that what was declared to Revenue Canada was binding for family law purposes. Dalgleish, which dealt with a post-1979 estate freeze, is wrong in following Karakatsanis.**

However, until these cases are overruled, the current case law provides that a gift of shares under a corporate reorganization is not excluded where there is no family trust. But, a family trust is recommended as the vehicle for the gift after marriage because an interest in family trust which held a business was excluded in Armstrong v Armstrong. Sooner or later, Dalgleish and Karakatsanis will be overturned.

(d) **The parent should gift the money to the child for purchase of the new common shares or in the alternative, the parent takes back the new common shares and gifts the new common shares to the child**;

(e) The donor of the gift must make a **declaration of gift as set out in Armstrong v Armstrong excluding the capital and income**;

(f) **The child cannot use his or her own money to purchase the new common shares; otherwise, there is no gift; (the argument that the growth of future value is the gift is one step removed and is more difficult);**

(g) **Don't use a promissory note** to set up payment for the new common shares to the child because forgiveness of the debt later does not constitute a gift (**Goodyer v Goodyer**);

(h) **Fairness, bona fides and disclosure to a spouse are key elements in ensuring that an estate freeze will be upheld if made during cohabitation. If the Client intends to set up an estate freeze during marital cohabitation, the spouse should be involved in consultations and made a beneficial owner of some of the preferred shares or be made one of the beneficiaries of the family trust** (**Serra v Serra**);

(i) **Timing is important**. If the transaction is during marital cohabitation, and there are marital problems or the transaction is shortly before the date of separation or death, the transaction is more likely to be successfully challenged (**Mittler v Mittler, Cohen v Zagdanski, Stone v Stone)**

(j) **The extent of the transfer of assets is important**. If the transaction puts all or most of the assets outside the spouse's net family property, then it is more likely to be set aside (**Stone v Stone**)

(k) **If the creation of a trust or estate freeze is before a marriage and the Client retains part of the interest while gifting an interest to children, it may stand up** (**Sagl v Sagl**). However, if there is

cohabitation before marriage and the trust or estate freeze has the effect of reducing future net family property, there may be a challenge.

(l) **If there is a lack of bona fides and an intent to cheat a spouse, then the transaction will be set aside** (**Stone v Stone, Cohen v Zagdanski**).

(m) **All aspects of the transactions must be carefully documented. The court will order rigorous financial disclosure and documentary disclosure if the transaction is challenged** (**Cohen v Zagdanski**).

(n) **During litigation, the Settlor, Donor and Trustees may be added as parties to the litigation in their trustee or director capacity and in their personal capacity. This expands the discovery process and disclosure process** (**Boris v Boris**).

(o) **The solicitor must have a well-documented file and written instructions from the Client,** because there is always a risk that the transaction may be challenged.

(p) **A marriage contract or cohabitation agreement should be completed if the Client is entering into a new relationship. The fact of the estate freeze should be disclosed as part of the negotiations.**

PART III -DEFINITION OF EXCLUSIONS UNDER THE FAMILY LAW ACT

3. Section 4 (2) 1 of the Family Law Act excludes from equalization the value of property owned at the Valuation Date which is acquired from a third person by gift or inheritance the date of marriage and that is not traced into a matrimonial home.

4. Section 4 (2) 2 excludes the income from such property if the donor or settlor expressly excludes it from a spouse's net family property.

5. Property owned at the Valuation Date traceable from items 1 and 2 is also excluded.

Part IV - DEFINITIONS OF GIFT VERSUS SALE

6. ***Black's Law Dictionary, 5th Edition, defines a sale as:***

A contract between two parties, called respectively, the "seller" (or vendor) and the "buyer" (or purchaser), by which the former, in consideration of the payment or promise of payment of a certain price in

money, transfers to the latter the title and the possession of property. Transfer of property for consideration either in money or its equivalent.

7. ***Black's Dictionary describes a gift as follows:***

A voluntary transfer of property to another made gratuitously and without consideration ... Essential requisites of "gift" are capacity of donor, intention of donor to make gift, completed delivery to or for donee, and acceptance of gift by donee.

8. In **Serra v Serra,** 2007 CanLII 2809 (ON S.C.) Justice Herman reviewed whether a transfer of shares after the husband's marriage from the husband's dying brother to the husband and to one of the family trusts was a gift. **No money was paid for the shares. Justice Herman held there was a gift. The fact that the transfer document stated, "*For value received the undersigned ... hereby sells, assigns, and transfers*" did not establish that there was a sale.** Justice Herman defined gift as follows:

[92] " A gift is the voluntary transfer of property without consideration (**Birce v. Birce** 2001 CanLII 8607 (ON C.A.), (2001), 56 O.R. (3d) 226 (C.A.) at para.17). It has the following elements: intention to transfer property; certainty as to the property to be transferred; certainty as to the recipient of the gift; and delivery and perfection of the gift by doing everything necessary to effect an irrevocable transfer (**Ruwenzori Enterprises Ltd. v. Walji**, [2004] B.C.J. No. 1147 (S.C.)).

PART V - PRE-1979 ESTATE FREEZE SET UP AS A SALE FOR SUBSTANTIAL CONSIDERATION TO CIRCUMVENT THE GIFT TAX ACT AND SUCCESSION DUTY ACT (STATUTES REPEALED IN 1979)

9. Until 1979, the Gift Tax Act and Succession Duty Act were in effect. Tax planners set up transfers under an estate freeze as a sale with consideration in order to avoid the tax.

10. Estate freezes set up to deal with the Gift Tax Act and Succession Duty Act should be distinguished from those set up after these laws were repealed.

11. In **Black v. Black** [1988] O.J. No. 1975 66 O.R. (2d) 643 31 E.T.R. 188 18 R.F.L. (3d) 303 13 A.C.W.S. (3d) 81 Walsh J. dealt with two issues with respect to estate freezes established in 1965 and 1969 under the Gift Tax Act and Succession Duty Act. The parties were married on June 13, 1964, and separated on March 13, 1981.

a. The husband was granted a pre-marriage deduction for his contingent interest at date of marriage in his grandparents' estates which vested 5 years after the marriage. The husband's claim that he did not "own" the interest in the estate until his right vested after marriage was rejected. He therefore lost the claim for the growth between date of marriage and date of separation.

b. The husband claimed that the potential and actual growth from the completion of the second estate freeze in 1969 (after the marriage) to the valuation date was excluded. Justice Walsh rejected this claim on the basis that there had been a purchase and sale, rather than a gift. Justice Walsh held:

[54]The husband and his brother purchased their Bemocoge Limited shares by transferring property already owned by them with a value of $92,635 and $1,157,768, respectively. They are thus completely unable to be classified as a gift and ineligible for exclusion under s. 4(2), paras. 1 and 5 of the Act."

12. **The leading authority is based on an estate freeze with a corporate reorganization that was set up as a sale, not a gift, to avoid gift tax prior to 1979. Justice Greer held that one couldn't take the position in family law that there was a gift if the position taken with the tax authorities was that there was a sale for substantial consideration. This is particularly so where the sale was set up to avoid gift tax and succession duty. See Karakatsanis v. Georgiou** [1991] O.J. No. 1298, 33 R.F.L. (3d) 263 27 A.C.W.S. (3d) 1016, Ont. C.J. – G.D.

13. In **Livermore v. Livermore** [1992] O.J. No. 2310 43 R.F.L. (3d) 163 36 A.C.W.S. (3d) 608 Ontario Court of Justice - General Division Milton, Ontario Clarke J. seems to have applied the **Karakatsanis** principle as although it is not clear what the facts were and why he did so other than referring to the "doctrine of preclusion". In other words, you can't say to the tax department that it is a sale, but in family law it is a gift.

PART VI - POST 1979 ESTATE FREEZES FOLLOWING REPEAL OF THE GIFT TAX ACT AND SUCCESSION DUTY ACT

14. **Once the Gift Tax Act and Succession Duty Act were repealed, estate and tax planners set up the transaction as a gift, not a sale.**

15. **An estate freeze usually involves a corporate reorganization.** One example is that the parent exchanges common shares for voting preferred shares with the value frozen at the value of the prior common shares

under a rollover under Section 85 of the Income Tax Act. New common shares without votes are issued to the children for nominal value, say $1.00 per share. The parent gifts the child the money for the new common shares. The child pays for the shares with the gift. Revenue Canada accepts that the parent has disposed of the common shares on a rollover. The capital gain the parent has as of the date of transfer is frozen. For income tax purposes, there is no disposition of the parent's shares until death. The future growth goes to the next generation. The children are not taxed on the capital gains on the new common shares until they dispose of them. The children obtain the future growth. The parent may also take back the new common shares and gift them to the children.

16. Another option is to create a family trust and make the child a beneficiary of the trust. The trust may hold the new common shares of a corporation.

17. Justice Magda **wrongly followed Karakatsanis v Georgiou** in **Dalgleish v Dalgleish** [2003] O.J. No. 2918 124 A.C.W.S. (3d) 322 Ontario Superior Court of Justice Family Court where the estate freeze was set up as a gift, not a sale. In Dalgleish, the estate freeze was set up after repeal of the Gift Tax Act and Succession Duty Act. The father had gifted the money to the son to purchase the shares in the corporation. Following **Karakatsanis**, Justice Magda included the value of the shares. This case should not be followed.

18. **Contrast Karakatsanis v Georgiou and Dalgleish v Dalgleish with Armstrong v. Armstrong** [1997] O.J. No. 4137 46 O.T.C. 274 34 R.F.L. (4th) 38 74 A.C.W.S. (3d) 807. In **Armstrong**, **Justice MacKinnon held that the husband's interest as a beneficiary of a family trust created in 1987 by the husband's father after the date of the son's marriage was a gift to the son and therefore was excluded property. It was part of an "estate freeze". There was no consideration flowing from the husband or any other beneficiary to the parent, settlor or to the trust. The case was distinguishable from Black v Black.**

19. **The trust in Armstrong included the following language which one finds in the usual Will today:**

- ***Any gift or benefit, including any income derived therefrom, in favour of any beneficiary taking under this indenture, who is married at the time of the receipt of such gift or benefit shall be excluded from the net family property of such beneficiary for all purposes of the Family Law Act, 1986, as amended from time to time, and shall not fall into any community of property that***

may exist between such beneficiary and his or her consort and, in the case of female persons, such gift or benefit shall be free from marital control.

PART VII - CURRENT LITIGATION ARGUMENTS ON INCLUDING OR EXCLUDING in NFP A GIFT OF SHARES TO A CHILD UNDER AN ESTATE FREEZE POST MARRIAGE

20. The current arguments with respect to whether the new common shares obtained by the child during marriage pursuant to an estate freeze and the appropriate responses are as follows:

    a. **Argument Against Exclusion** - that the parent receives consideration when the common shares are exchanged for preferred shares; therefore there is no gift. **Counter-Argument in Favour of Exclusion** – it is correct that the parent receives consideration for his or her shares but that has nothing to do with the gift of the new common shares to the child.

    b. **Argument Against Exclusion** – The gift of future growth was denied as an exclusion in **Black v Black**. **Counter-Argument In Favour of Exclusion – the Black case is distinguishable** because the contingent interest in the estate was valued as property at date of marriage, the fact of later vesting after marriage did not mean it was not an asset at marriage. Black and his brother purchased shares after marriage by a transfer of valuable property so that there was no gift.

    c. **Argument Against Exclusion** - Revenu e Canada accepts the exchange of preferred shares for common shares as one transaction. Revenue Canada does not treat the transaction as a gift or disposition which triggers immediate tax consequences. **Counter-Argument in Favour of Exclusion** – Declarations to Revenue Canada are no longer binding for family law purposes. One must assess the transaction for family law purposes on its merits in the family law context.

PART VIII - COURTS NOW DO NOT HOLD THAT PRIOR INCONSISTENT DECLARATIONS ARE BINDING – DECLARATIONS ARE MATTERS OF EVIDENCE TO BE WEIGHED

21. As one knows from reading Justice Greer's family law decisions in recent years, courts do not hold that prior declarations for the tax department or other purposes are necessarily binding in family law. Courts weigh these declarations as only factors in evidence.

22. In many cases, it appears that the modern approach of the courts has changed in that income declarations for income tax, banking, credit, and other purposes, are simply part of the evidence to be considered, and are not necessarily determinative. Courts look to the substance of the transaction from a family law point of view to achieve fairness:

(a) **The Federal Child Support Guidelines came into effect on May 1, 1997, with new rules for assessment income for child support purposes. These rules are different from the Income Tax Act.** Accountants are frequently retained to reassess income for support purposes.

(b) **For child and spousal support purposes, what parties report to the income tax department is not binding on a family law court.** This is evident in child and spousal support cases in which there is a claw back of expenses declared on income tax returns into income for support purposes plus a gross up (see for example, **Sarafinchin v Sarafinchin** [2000] O.J No. 2855 189 D.L.R. (4th) 741 98 A.C.W.S. (3d) 856 Sachs J.

(c) In **Sagl v Sagl**, (1997) CanLII 12448 (On. S.C.) Justice MacDonald took the following approach: **For purposes of determining the interest of a spouse as one of the beneficiaries in a discretionary family trust, the court may take a fair and equitable approach "having regard to trust law, the definition of property and the evidence was of what the intention was at the time of the creation of the Trust". The court may treat the trust as though there was a realization among all capital beneficiaries and assess the spouse a pro rata share. The court may disregard:**

(i) a statement of net worth filed with or credit application in which the spouse claimed that sole benefit of the trust assets, that:

(ii) that the husband treated the trust assets as his own during marriage;

(iii) that the trustees were friendly trustees;

(iv) that the husband controlled the trust until he resigned as trustee.

(d) **Courts have pierced the corporate veil for enforcement of equalization and support purposes** by attaching the income of the spouse's corporation as income for support purposes

(**Arsenault v Arsenault** [1998] O.J. No. 1423 Ont. Ct. J. G.D., Wood, J.) by charging assets of the corporation of the payor spouse with the support obligation (**Wildman v Wildman** [2006] O.J. No. 3966 Ont. C.A.) and by transferring to the dependant spouse assets of the corporation in which the payor is the beneficial owner of the shares in satisfaction of the support obligation (**Lynch v Segal** [2006] O.J. No. 5014 Ont. C.A.)

(e) **Courts may disregard a family debt or discount it substantially in the equalization calculation**. **Cade v. Rotstein**, 2004 CanLII 24269 (ON C.A.)

(f) **In Pecore v. Pecore**, 2007 SCC 17 (CanLII), **Justice Rothstein held that a parent who transfers an asset into joint tenancy as to the parent and the adult children, may hold beneficial ownership until date of death, and that the asset then may pass by survivorship to the children. Probate tax avoidance did not seem to be a concern. Justice Rothstein wrote at paragraph *54:" Should the avoidance of probate fees be of concern to the legislature, it is open to it to enact legislation to deal with the matter."***

PART IX - PLANNERS SHOULD AVOID PROMISSORY NOTES AS FORMS OF PAYMENTS FOR SHARES – FORGIVENESS OF DEBT IS NOT A GIFT FOR FAMILY LAW PURPOSES

23. A promissory note should not be set up as a form of payment for the transfer of shares. First of all, this is consideration which defeats the argument of gift. Secondly, forgiveness of debt in the family law context does not constitute a gift.

- **Goodyer v Goodyer** 1999] O.J. No. 29 168 D.L.R. (4th) 453 85 O.T.C. 258 84 A.C.W.S. (3d) 1139, Ont. C.J. G.D
- Fehr v. Fehr, 2003 MBCA 68 (CanLII)

PART X- PRE-MARRIAGE TRUST UPHELD WHERE CLIENT'S INTEREST IN ASSETS DILUTED

24. ***A court may uphold a trust set up before marriage which makes the spouse one of many beneficiaries of the property.*** **Sagl v Sagl**, (1997) CanLII 12448 (On. S.C.)

PART XI - TRANSACTIONS DURING MARRIAGE - BONA FIDE PURPOSE NOT PRE-SEPARATION PLANNING – TRANSACTION UPHELD

25. ***A court may hold that an estate freeze set up during cohabitation was valid and the assets should not be included in net family property. Bona fides, context and timing are important factors;***

(a) ***the value of the common shares was not included in net family property where there were no marital problems at the time of the estate freeze and it was set up 5 years before separation;*** **Mittler v. Mittler** [1988] O.J. No. 1741 17 R.F.L. (3d) 113 12 A.C.W.S. (3d) 125 Supreme Court of Ontario - High Court of Justice Toronto, Ontario;

(b) **the trusts were valid and not included where the wife had knowledge of the estate and trust plans and was a beneficiary of the trusts,** Serra v Serra, 2007 CanLII 2809 (ON S.C.) reversed on other matters [2009] O.J. No. 432, 2009 ONCA 105, 93 O.R. (3d) 161.

PART XII - FRAUDULENT CONVEYANCES DURING COHABITATION

26. ***Where a dying spouse disposes of assets to children of his first marriage to defeat the claims of his second spouse, the court may roll back the transfers as fraudulent conveyances,*** *deem the Valuation Date to be the date before the transfers, and include the property in net family property equalization.* In **Stone v Stone**, 2001 CanLII 24110 (ON C.A.)

PART XIII – TRANSACTION IS A SHAM

27. **A court may include in the value of of net family property to be equalized an estate freeze that is set up to "cheat" a spouse or defeat the claims of the spouse.** In **Antflick v. Antflick [1980] O.J. No. 1240 No. 31217/78** Ontario Supreme Court - High Court of Justice **Walsh J. found that a pre-separation trust was a sham**.

"***.. no meetings of the trustees have at any time been held and the trust has been, since its creation, under the absolute control and management of the husband.*** *The trust is said to be for the benefit of his wife and his three children; the children to receive the capital, the income in the discretion of the trustees to first meet the needs of the wife.* ***Since its inception the trust has made no payments of any kind to the wife. ... It is submitted on behalf of the wife that***

the purported trust is a "sham" and all of its assets are, in fact, and must for the purposes of this proceeding be taken as assets of the husband. A detailed analysis of the corporate documentation of the assets comprising the trust and the manner in which the trust has been operated since its inception, lead only to this conclusion. Be that as it may, its integrity to date has not been challenged by the taxing authorities."

28. ***A court may find that a corporation is a sham intended to defeat a spouse (see paragraph 13 (c) supra and also*** In **Merklinger v. Merklinger**, 11 O.R. (3d) 233 [1992] O.J. No. 2201 affirmed 1996 CanLII 642 (ON C.A.)***.***

PART XIV - RIGOROUS DISCLOSURE DURING LITIGATION WHILE TRANSACTION DURING COHABITATION CHALLENGED AND UNDER SCRUTINY

29. ***Courts will order rigorous disclosure but ultimately it is up to the trial judge to detemine if the intention was to cheat the spouse:***

(a) Justice Lane in **Cohen v. Zagdanski** [2006] O.J. No. 3729 151 A.C.W.S. (3d) 398 Ont. S.C.J., Justice Lane referred to the fact that the trial judge would determine whether the intent of the transaction was to "cheat" the wife or not.

"The fact remains, as Mr. Sternberg emphasized, ***the trial judge will make findings of whether Henry entered into the freezes and other transactions intending to cheat his wife or not. If not, neither the separation date value, nor the present valuation of the assets which Henry disposed of in those transactions prior to separation is relevant.*** *As will be developed in detail below, this case has reached the point at which further exploration of transactions relating to these assets should be quite limited until Johanna has established the right to set the freezes aside and the further need to trace the relevant assets in aid of her equitable rights as established in the ultimate judgment."*

Justice Lane ordered full disclosure regarding the transactions:

." In my decision of December 1, 2000 I ordered that Henry would make full disclosure as to the freezes, the values involved, the reasons for them and Henry's on-going role. I also directed that every aspect of Henry's assets at the valuation date, including what he did prior to separation, allegedly to reduce his NFP, was to be disclosed. It is my understanding that, at least for

the most part, that has been done; in any event it has been ordered. That is, generally speaking, the realm which the plaintiff is entitled to explore in the matrimonial and 1993 cases: the value of Henry's assets at separation broadly defined, including the efforts said to have been made to reduce his NFP."

PART XV - COURT ADDING FATHER BOTH AS TRUSTEE AND IN PERSONAL CAPACITY DURING LITIGATION WHEN TRANSACTION IS CHALLENGED

30. In Boris v Boris, 2005 CanLii 6386, (2005) 13 R.F.L. (6th) 92, Ont. S.C.J., Scime, J., the issue was whether the husband's father personally or as trustee of a trust held property trust for the husband that should be included in the husband's net family property. The Wife claimed that "the transactions amounted to a 'net family property freeze' while the husband maintained that the transactions constituted "an estate freeze, part of prudent income tax planning". the husband's father had built up a business worth 100 million dollars. On the date of the husband's marriage, the husband had 1/9th of the common equity of his father's company, MCL. After the marriage, the husband his two siblings and their father transferred their shares in MCL to a holding company, 967, and received common shares in 967. The husband's father continued to control the companies. The husband and his siblings then transferred the 967 shares to 967 in exchange for special shares, with a fixed redeemed value. The husband's father then issued new common shares and gifted them to the Boris (1993) Family Trust. The husband then surrendered his share surrendered his right to future appreciation of the 967 shares. The husband then became one of 9 beneficiaries of the Boris Family Trust (the husband, his parents, his siblings, and the grandchildren of his parents). At separation, the husband's "only substantial assets was his 1/9th share interest of MCL and later 967, which, for no compensation, he has transferred and now holds non growth Class B Special Shares and a [contingent] discretionary interest in the Family Trust". The trustees had absolute discretion but were directed by the husband's father. The

husband's father was added as a party both in his personal capacity and as Trustee and the court granted the wife the sum of $50,000.00 as interim costs (disbursements) for experts to evaluate the husband's net family property.

PART XVI - CONCLUSION

31. **My summary, submissions and recommendations are set out in Part II of this paper. Good faith and careful lawyering help people sleep at night.**