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Estate-Owned Operating Companies: Key Considerations in Trustee Powers

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Introduction

Estates that own active businesses are a special, but not entirely uncommon, situation. Estate trustees may come to hold a controlling, or significant, interest in active businesses for several reasons. One of these reasons may be tax planning involving spousal trusts. Particularly when the shares of an active business corporation have a low adjusted cost base ("ACB") and a high fair market value ("FMV") (which value was likely built-up over a good part of an owner/manager's lifetime running the business), it may be practical for the shares to be rolled into a testamentary spousal trust in order to avoid the deemed disposition of the shares at their FMV until the death of the last-to-die of two spouses.[1] Testamentary spousal trusts are taxed at graduated rates, as opposed to *inter vivos* trusts, which are taxed at the highest marginal tax rate.[2] Further, unlike *inter vivos* trusts or, indeed, other testamentary trusts, spousal trusts are not subject to the *Income Tax Act's* ("ITA") twenty-one year deemed disposition rule.[3] As such, testamentary spousal trusts may be an effective means of holding the shares of an active business corporation during the lifetime of a surviving spouse.[4]

Another reason for an estate coming to hold active business assets may come as the result of a testator's spouse and/or children being residents or citizens of the United States. With a stringent gift and estate tax regime in place in the United States, and due to shifting marginal estate tax rates (which in 2013 will be as high as 55%, with only $3 million in available exemptions from estate tax liability),[5] Canadian parents or spouses may establish one or more testamentary trusts in their Canadian Wills in an effort to shield property from exposure to U.S. estate taxes.[6]

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[1] "Rollovers" occur at the shares' ACB, in this case, pursuant to subs. 70(6) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th supplement), as amended [ITA]. The deemed disposition of an individual's capital assets immediately prior to his or her death occurs pursuant to subs. 70(5) of the ITA.

[2] ITA, *supra* note 1 at subs. 122(1).

[3] I*nter-vivos* trusts are subject to the "21-year deemed disposition rule" under subs. 104(4) of the ITA, *supra* note 1. Spousal trusts are not part of 21-year rule regime under subs. 104(4).

[4] Note that the trustees of a testamentary spousal trust may be different from the executors and estate trustees of a testator or testatrix's Will. Practitioners should discuss the ability to appoint different trustees with their clients in order to best plan for the management of an active business. for a more in depth discussion of spousal trusts, see Pearl Schusheim, "Spouse Trusts: Tips and Traps—Part 1," 47(6) *Canadian Tax Journal* 1525-44 (1990) and Roanne Bratz, "Spouse Trusts: Tips and Traps—Part 2," *Canadian Tax Journal* 477-97 (2000).

[5] For more information on U.S. gift and estate taxes, see Internal Revenue Service ("IRS") Publication 950. See also Matthew Campione, Esq, "Federal Estate Tax Still Headed in the Wrong Direction," *Forbes Magazine*, January 9, 2012. Note that a 5% surtax will apply on estates between $10 million and $17 million, meaning that the estate tax rate will be, effectively, 60% for such estates.

[6] A discussion of U.S. estate taxes and estate tax liability is beyond the scope of this paper. However, consider the situation where a Canadian testator holds all of the issued and

Finally, estate trustees may come to hold active business assets simply due to a lack of, or poor, estate and Will planning. Estates may also come to hold the shares of an active business due to unexpected reasons. For example, an individual may decease holding a large number of preferred or voting "freeze" shares that he or she obtained as part of an estate freeze. Although the plan may have been for the shares to have been slowly redeemed during the deceased's lifetime, his or her untimely death may have left his or her estate holding a controlling interest in a business that may not have the resources available to effect a timely redemption, and accordingly the estate may not be able to sever its relationship with the business.

Whatever the reason may be that estate trustees ultimately hold shares in an active business, Wills should be drafted and properly planned to include a number of trustee powers that will equip the estate trustees to manage and administer a business owned by an estate. Trustee powers are not always given due consideration in Will planning. In many cases, testators settle for boilerplate or standard clauses without properly reflecting upon the possible eventuality of one or more trustee powers being relied upon in the management of a business. This paper will discuss several worthwhile trustee provisions that may be included in Wills, and their usefulness in the event that an estate owns and operates an active business. This paper will also touch upon certain key considerations when putting together an estate plan that includes an estate holding a controlling interest in an active business.

Fiduciary Obligations – Estate Trustees and Corporate Directors

Both the directors of a corporation and the trustees of an estate hold fiduciary roles. In the case of the directors of the corporation, it is trite that their fiduciary duties are primarily towards the corporation, its shareholders, and other directors. In the case of estate trustees, it is also well understood that their fiduciary obligations are towards the beneficiaries of the estate. For example, the trustee of a testamentary spousal trust owes both a fiduciary obligation to the spouse for whose benefit, during his or her lifetime, the trust was established, as well as to the children or other beneficiaries who stand to inherit the remainder of the spousal trust once it is distributed to them following the spouse's death. This may be the case notwithstanding the fact that the latter may have only a contingent interest with respect to the assets held in the spousal trust.

When estate trustees hold title to all of the issued and outstanding shares of an active corporation, the question that often arises is whether one or more of the trustees should be appointed as directors of the corporation.[7] In many cases, the deceased may have

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outstanding shares of a Canadian business at this time of his death. The FMV of the shares is $20 million dollars. Rather than being held in trust, the shares are distributed outright to a U.S. resident beneficiary (the testator's only child) and therefore irretrievably come to form part of that beneficiary's worldwide property. Should the beneficiary unexpectedly decease in short succession of the testator, the child's estate would immediately face a U.S. estate tax liability potentially in excess of $10 million. This tax liability may not be able to be met without selling the active business, which may not be feasible.

[7] See Rosanne Rocchi, "Administration of Active Business Assets in Estates," in *Special Lectures of the Law Society of Upper Canada*, *1996, Estates: Planning, Administration and Litigation* (Toronto: Carswell, 1996) at 455 in which paper Ms. Rocchi recommends that one or more estate trustees appoint themselves as directors of the corporation in order for the affairs of the corporation to proceed in a coherent and responsible manner.

been a director during his or her lifetime and a vacancy may have been created as a result of his or her passing. In some cases the deceased may have been the *only* director of the corporation, making the need to appoint a replacement director all the more urgent.

Federal and provincial business corporations' legislation, including the Ontario *Business Corporations Act,*[8] makes it clear that the directors of a corporation must pass resolutions with respect to certain critical corporate issues. These include, *inter alia*:[9]

1. declaring periodic dividends payable to shareholders of the corporation in respect of their shareholdings;

2. approving financial statements in respect of the corporation's fiscal year;

3. declaring bonuses; and

4. signing corporate resolutions and other documents on behalf of the corporation, including signing authority in respect of the corporation's bank accounts and contracts entered into between the corporation and third parties.

Declaring dividends may be critical in providing a source of income for one or more life tenants of the estate—often where the shares are held by a testamentary spousal trust that is being administered by the estate trustees. It follows that one or more estate trustees may need to be appointed as a director of the active business corporation in order to be in a position to arrange the necessary circumstances and funding to be able to declare dividends. Interestingly, one or more of the estate trustees may be required to either act as a director of the corporation or appoint a director in order to fulfill his or her fiduciary obligations towards the beneficiaries of the estate.[10] As such, the deceased's Will should provide the necessary powers to the estate trustees to appoint themselves as directors of any corporation controlled by the estate and to manage an active business, should the need arise. It also follows that the trustees should have the power to take out any necessary insurance policies in order to protect themselves, and the assets of the estate, where indemnification exists, from potential liability as a result of an innocent mistake while serving a director of a corporation.

A further consideration with respect to dividends is who is entitled to receive capital dividends; is it the income beneficiary of an estate, or its capital beneficiary or remainder person? I raised this issue in a paper to this same audience in 1982 and I note that it remains, to this day, open to multiple approaches. If there is a holding company that owns all of the issued and outstanding shares of an operating company, and the

[8] R.S.O. 1990, c. B.16 [OBCA].
[9] Rocchi, *supra* note 7 at 456-457.
[10] See *Re Fleming,* [1973] 3 O.R. 588 (H.C.) [*Re* Fleming] in which case the then High Court of Ontario held that fiduciaries could not do as corporate directors what they would be prevented from doing as estate trustees. Accordingly, the role and duty of estate trustees who control an active business corporation through an estate effectively trumps that of the corporate directors. Estate trustees cannot, therefore, administer the corporation in such a manner that does not accord with the best interests of the beneficial shareholders of the corporation, who are the beneficiaries of the estate. *Re Fleming* remains good law today and has been applied by courts in Ontario and British Columbia. See *Clock Holdings Ltd. v. Braich Estate*, 2008 BCSC 1697 [*clock* Holdings] and *Re Carley Estate*, 2 E.T.R. (2d) 142 (Ont. Gen. Div.).

operating company is sold, a potentially significant amount will be credited to the holding company's capital dividend account ("CDA") on account of the sale. Capital dividends may be distributed by the estate trustees to income beneficiaries on a tax-free basis; alternatively, the capital dividend may be on account of capital and, therefore, should arguably be reserved for the benefit of the capital beneficiaries. From a tax perspective, it is clear that dividends that are paid out of a CDA are received by the beneficiary as income, albeit on a tax-free basis.

A likely answer or solution to the unresolved question is the estate trustees' duty to keep an even hand between beneficiaries.[11] If a testator wishes for his or her income beneficiaries to receive capital dividends, specific powers should be included in the Will to permit estate trustees to *not* keep an even hand in certain situations and to enable estate trustees to make distributions to beneficiaries as they see fit, in their absolute discretion. Otherwise, if it is the testator's wish that his or her income and capital beneficiaries be treated consistent with their designated allotment and that the trustees keep an even hand, specific provisions to this effect should be included in the Will. Arguably, the FMV of capital assets held in the estate, including active business assets, should be valued at the date of death in order to enable the estate trustees to administer with an even hand among the beneficiaries going forward. The more specific the powers and provisions that are included in a Will to this effect, the greater the likelihood that any future challenges or disputes will be diminished or persuasively addressed.

Creditor Proofing

An attractive feature of estates owning active businesses is the creditor proofing possibilities that the structure provides. Estates in Ontario benefit from the protections afforded by subsection 38(3) of the *Trustees Act*, which provides that no action may be brought against the estate of a deceased person more than two years after the date of the deceased's death.[12] Section 19(1)(a) of the *Limitations Act* provides that the limitation periods contained in the *Limitations Act* (i.e. no limitation for environmental claims) trump all other limitation periods contained in other Ontario statutes, with the exception of those provisions listed in Schedule A to the *Limitations Act*.[13] Subsection 38(3) of the *Trustee Act* is listed in Schedule A to the *Limitations Act*.

By operation of s. 19(1)(a) of the *Limitations Act*, the ultimate two-year limitation period from the date of an individual's death governs a plaintiff's ability to bring an action against the estate. The doctrine of discoverability, which is a component of the section 4 limitation period in the *Limitations Act,* is therefore irrelevant with respect to the time limit for bringing actions against estates. The Court of Appeal for Ontario confirmed this view in *Washkowski v. Hopkinson Estate*.[14] The Court of Appeal held that, due to the clear language of subsection 38(3) of the *Trustee Act*, the discoverability principle does not apply to actions against estates, which are governed by a strict two-year time limit.[15] The case dealt with the liability of an estate with respect to negligence on the part of the deceased that led to a motor vehicle accident.

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[11] See *Clock Holdings, supra* note 10 at para. 184, citing *Re Fleming, supra* note 10.
[12] R.S.O. 1990, c. T.23 [*Trustee Act*].
[13] S.O. 2002, c. 24 Sch. B at s. 19(1)(a).
[14] 47 OR.. (3d) 370 [*Washkowski*].
[15] *Ibid* at para. 16.

Although the facts of the case are not directly related, the principle in *Washkowski* may nonetheless be applied to the context of an estate-owned active business. To the extent that dividends are regularly paid to the estate from the active business, the resulting income may be protected from liability. If the creditors of an active business pursue their claims against the business, although the corporation's assets may be at risk, the estate itself, and the estate trustees, in their personal capacities, are protected from liability. Evaluating the risk and possibility of future claims and actions, and the benefits of creditor protection, may also be relevant considerations when building an estate plan and determining whether to include a spousal trust. If such a plan is implemented, as long as sufficient powers and discretion are provided to the estate trustees to lend funds to third parties, including individuals and corporations, the trustees may loan funds paid to the estate by way of dividend from an active business corporation back to the corporation and secure such loan with a general security agreement ("GSA"). The GSA may, in turn, be registered at the personal property registry, providing enhanced creditor protection to the business and to the estate.

Selecting Estate Trustees and Conflicts of Interest

In cases where estate trustees may have to run an active business, including make decisions in respect of the business' management and/or appointing themselves as corporate directors, special consideration needs to be given as to who should be selected as an estate trustee, and the rule against self-dealing. It is not uncommon for one or more sons or daughters to be involved in a parent's active business, while other children may not be so actively engaged. In such a situation, if both children are estate trustees, one sibling may want to purchase the others' interests in the active business—or make such a purchase from the estate—in order to gain complete control of the corporation.[16]

Assume that the active business is held in a testamentary spousal trust and the estate trustees are also the trustees of the spousal trust. Further assume that the estate trustees are the surviving spouse, the testator's son and the testator's daughter. The testator's daughter is already a major shareholder and is actively involved in and, subsequent to the testator's death, runs the active family business that is now held in the spousal trust. She decides that she wants to hold all of the shares of the business and resolves to purchase the shares from the spousal trust. This situation is not uncommon and gives rise to several concerns.

First, at common law, the intended purchase by the daughter of the shares in the active business from the trustees of the spousal trust violates the rule against self-dealing. In general, the same person cannot be both a purchaser and a vendor.[17] Secondly, at equity, the daughter would be acting in breach of her implied fiduciary obligation to avoid conflicts of interest and she, therefore, would be deemed to not be in an objective

[16] Other considerations come into play in such situations. If carefully designed, estates could be "equalized" with other assets and insurance, such that the sibling who is not involved in the business receives an equal share of the estate, in terms of FMV, as the sibling who inherits the shares of the corporation. Otherwise, unanimous shareholders' agreements could be in place among shareholders, which agreements the shareholders would need to abide by once they inherit shares in the corporation. These agreements could include buy/sell provisions (or a separate buy/sell agreement could be instituted) that respond to such situations.

[17] *Halsbury's Laws of England*, 16 Hals. (4th) at para. 1457. See also Rocchi, *supra* note 7 at 494.

position with respect to the beneficiaries of the trust and could be required to disgorge any profits indefinitely into the future, subject to laches or other equitable defences.[18] Accordingly, the purchase could not proceed unless, *inter alia*:

1. the Will provides that trustees may engage in self-dealing, notwithstanding the fact that they would be otherwise conflicted *and* the other trustees and any relevant beneficiaries consent to the purchase;[19] or

2. the daughter applies to the Court and seeks an Order approving the purchase, justifying the purchase to be in the best interest of all relevant beneficiaries.[20]

In either case, the office of the Children's Lawyer would often times need to be involved and the Children's Lawyer's approval could be necessary in order to proceed with the purchase. This approval would likely be contingent on the daughter providing adequate disclosure and establishing that the purchase would be proceeding at FMV and that the beneficiaries would be no worse off if she were to effect the purchase from the spousal trust.[21] In this respect, every case would turn upon its own facts.[22] However, without specific powers in a Will permitting the daughter to orchestrate the purchase, a potentially complex, costly and protracted application could take place in order for the shares in the business to pass on to her. Alternatively, the daughter may have had to resign or be removed as an estate trustee, which may or may not have been feasible, convenient or advisable in the circumstances.

This routine example highlights not only the importance of carefully drafting trustee powers to account for possible future situations, but also the prudence of selecting estate trustees to account for future circumstances. Trustees who are potential buyers should be noted as such in Wills, so that it is abundantly clear what the testator's or testatrix's wishes and intentions were at the time his or her Will was prepared, including as to whether a buyer could retain his or her vote, which could have decisive consequences in majority approval situations. In the above example, had the testator appointed an independent or professional trustee in respect of the testamentary spousal trust, as opposed to his own spouse and children, the sale to the daughter may have taken place without any risk of it being deemed voidable under the common law or the law of equity. Often, testators may not want to appoint a professional trustee in an effort to reduce administrative costs and fees associated with managing the estate. Such

[18] *Ibid*.
[19] See *Thompson v. Thompson*, [1985] 2 All E.R. 720 (CA). See also *Re Leslie*, [1972] 3 O.R. 297 (H.C.).
[20] See *Re Mitchell* (1970), 12 D.L.R. (3d) 66 (ON CA).
[21] The tax consequences of the purchase should also be consider. Since the spousal trust would be disposing of the shares, it would realize a capital gain. If the business has grown in value over a course of decades (as may be the case with family businesses) and if no estate freeze was implemented during the testator's lifetime, the resulting capital gain may be sizeable. See *Field v. Banfield*, [1933] O.W.N. 39 (H.C.) and
[22] Consider the still leading case of *Rose v. Rose* (1914), 32 O.L.R. 481 (C.A.), in which case the testator's Will provided his three sons with the power to purchase shares in a corporation held by him at the time of his death, and subsequently held by his estate. The son who also acted as estate trustee ultimately purchased the shares. The beneficiaries of the estate argued that the shares were to be held in trust for their benefit. Although the Court ultimately held that the sale was made outside of the estate, and therefore not voidable, the Court also held that a purchase would be voidable under the terms of a trust or a Will if it resulted in a devaluation of the estate.

costs may need to be balanced against potential future acrimony and litigation, which may deplete not only the estate's assets, but also those of its beneficiaries.

Key Tax-Driven Trustee Powers for Estate-Owned Active Businesses

As a result of the issues discussed in this paper, practitioners must carefully consider and evaluate whether a testator's or testatrix's estate is likely to control a business when preparing his or her Will. If that is the case, it is often useful for the testator or testatrix to be aware of and weigh various alternatives (including appointing a professional trustee) and different circumstances that may arise, depending on his or her wishes and instructions. Central to the testator or testatrix's Will are the powers that his or her estate trustees will have in respect of business assets.

In addition to the powers previously discussed, which include the powers to:

1. carry on business;

2. appoint directors and to vote shares of the business;

3. make loans to third parties and corporations;

4. keep or not keep an even hand among beneficiaries; and

5. continue to act and engage in transactions with the estate that would otherwise give rise to a conflict of interest,

practitioners should also consider including additional tax-driven powers in Wills where there is a reasonable likelihood that an estate will come to hold a controlling interest in an active business. These powers include the power to:

1. engage in estate freezes or other corporate reorganizations in the spousal trust or in the estate (i.e. permit post-mortem freezing);

2. maximize tax planning, including lifetime capital gains exemption ("LCGE") planning for the benefit of the estate's beneficiaries;[23]

3. incorporate corporations and make distributions to any such corporations for the benefit of one or more beneficiaries of the estate; and

4. settle trusts, whether Canadian trusts or foreign trusts, for the benefit of one or more beneficiaries of the estate, particularly non-residents.

All of the above powers can at times all be of benefit in a common scenario. In some cases, it may be necessary reorganize a corporation and issue freeze shares, or otherwise purify a corporation through some form of tax-driven reorganization, in order for the corporation's growth shares to meet the test for qualifying small business corporation shares, in order for the capital beneficiaries of an estate to claim the LCGE in respect of shares that are distributed to them.

[23] The lifetime capital gains exemptions is currently available in respect of "qualifying small business corporation shares," as that term is defined under section 110.6 of the ITA. The current available deduction is $750,000 in tax-free capital gains.

Under section 107 of the ITA, distributions of shares from a trust or an estate to beneficiaries may qualify to occur on a tax-free basis, but only so long as the beneficiaries in question are Canadian resident taxpayers.[24] If the beneficiaries are not Canadian resident taxpayers, a capital gain to the trust results upon the distribution, with capital gains taxes payable by the estate trustees or the trustees of the applicable trust.[25] In many cases, it may be impossible to predict whether one or more beneficiaries of an estate may become a non-resident of Canada after the testator's passing. Often, the shares of a business may be held in a family trust for many years after a testator's death, and ultimately distributed to capital beneficiaries only after a lengthy deferral period. Many changes may take place in the intervening years, and it is important for Wills to provide estate trustees with the necessary powers to plan for, and to execute, tax-effective strategies, in response to evolving circumstances. If beneficiaries move to the United States, with sufficient powers and flexibility built into a Will, the estate trustees may incorporate unlimited liability corporations in one or more Canadian jurisdictions and distribute shares to such corporations for the benefit of the beneficiaries. This will avoid a capital gains tax liability in Canada, as well as some complex cross-border traps, although U.S. tax consequences to the beneficiary, including U.S. estate tax consequences, are recommended to be evaluated.

In a similar vein, by providing estate trustees with the power to maximize LCGE planning, as they in their absolute discretion see fit, trustees may engage in planning and make appropriate distributions among beneficiaries that will result in an effective maximization of the LCGE. The feasibility of such distributions will depend on the circumstances of each individual case. Nonetheless, the flexibility that such a power could provide to the capital beneficiaries of an estate can be of considerable value.

Conclusion

Although often ignored, or considered mere "boilerplate," it can be beneficial to determine what trustee powers and provisions may be useful in a Will, particularly if the testator holds a controlling interest in, or all of the issued and outstanding shares in the capital of, an active business. This paper has discussed several powers that may be included in Wills when there is a possibility that the controlling share of an active business will be held by an estate. These powers are premised on different planning considerations, including managing the business, creditor-proofing and avoiding, or accounting for, potential conflicts of interest, as well as tax planning considerations. However, by no means is the list of enumerated powers provided in this paper exhaustive. Once again, careful planning, thought and consideration is valuable in all cases involving the possibility of estate trustees holding a controlling interest in businesses.

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[24] ITA, *supra* note 1 at s. 107(2).
[25] *Ibid* at s. 107(2.1).