

## FAMILY LAW FOR NON-FAMILY LAWYERS

PAPER 2.1

# Corporate and Tax Issues under the New Family Law Act

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## **CORPORATE AND TAX ISSUES UNDER THE NEW FAMILY LAW ACT**

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### **I. The Scenario**

1. Ron and Sarah commenced cohabitation in 1988 and married in 1990. They have two children of their marriage. Sarah is 50 years old and a homemaker. Ron is 58 years old, the CEO and sole shareholder of a company called Nikko Inc., which manufactures and sells auto parts. Nikko was incorporated in 1983. The issued share capital of Nikko is as follows: Ron has 200 Class A voting common shares and 1000 Class C non-voting preferred shares. Ron and Sarah are both directors of the company. Ron is the President and Secretary.

2. Ron is also the sole director as well as the President of Elco Holdings Inc. Sarah is the Secretary. Elco Holdings Inc. is the registered owner of commercial property in Vancouver, with a tax assessed value of \$5,000,000. Elco Holdings Inc. was incorporated in 1983, at which time Ron was issued 200 Class A voting common shares. In 1995 Ron exchanged his 200 Class A voting common shares for 1000 class C non-voting preferred shares, Ron was issued 200 new Class A voting common shares, and Sarah was issued 200 Class B non-voting common shares.

3. Sarah is also the beneficiary of a discretionary trust. The trust was settled in 1999 and has, since 1999 owned 100 Class B non-voting common shares of Parentco Inc. Sarah’s father owns 100 Class A voting common and 1000 Class C non-voting preferred shares of Parentco.

4. Ron has a corporate and tax lawyer as it relates to his business interests. Ron also has an accountant who does all of his corporate and personal taxes, including Sarah’s tax return. The parties separated on September 1, 2013 and wish to reach a negotiated settlement with the assistance of their counsel. The new *Family Law Act* (“FLA”), which came into force on March 18, 2013 (and replaced the *Family Relations Act* (“FRA”)), applies to them.

5. An organizational chart for Ron and Sarah’s corporate interests is attached as Exhibit 1.

## II. Required or Helpful Financial Information and Avoiding Conflicts

6. As the corporate and/or tax lawyer in the aforementioned scenario, you have access to information and documents relevant to a family law case, and this has not changed since the introduction of the *FLA*.

7. The new *FLA* identifies two classes of assets—“family property” [defined in s. 84] and “excluded property” [defined in s. 85]. “Family property” is essentially everything that is not excluded. Insofar as it relates to corporate assets, s. 84 reads:

### Family property

84(1) Subject to section 85 [*excluded property*], family property is all real property and personal property as follows:

- (a) on the date the spouses separate, property
  - (i) that is owned by at least one spouse, or
  - (ii) in which at least one spouse has a beneficial interest;
- (b) after separation, property
  - (i) acquired by at least one spouse, or
  - (ii) in which at least one spouse acquires a beneficial interest,

that is derived from the property referred to in paragraph (a) or from the disposition of that property.

(2) Without limiting subsection (1), family property includes the following:

- (a) a share or an interest in a corporation;

...

8. As the corporate and/or tax lawyer, you may be asked by your client to produce documents in your possession or control required for the parties to effect a settlement. The following documents are essential:

- Constatng Documents—with share rights and restrictions
- Central Securities Register
- Shareholders Agreements and Family Trust Deeds
- Resolutions issuing shares

9. You may also be asked to provide corporate and income tax advice with respect to the separation of the parties’ financial affairs, which could include the transfer on a tax-deferred basis of cash from an active company ultimately being retained by one party (in this case, Elco Holdings Inc.) to a new company whose shares will be solely owned by the other party. In these circumstances, you will likely be instructed to work with the corporate accountant, who has access to pertinent information required for the property division work, including the cost basis of the shares, paid up capital of shares, and tax accounts of the companies (CDA, GRIP, RDTOH).

10. It is possible for you to represent both parties in this situation provided you are not giving any advice with respect to the parties’ rights under the *FLA*, and provided both parties understand what role you will play in this context. As property division work will be performed for both parties, the Law Society of BC requires lawyers in these circumstances to obtain the parties’ consent. This should be addressed directly in the retainer agreement, which must be executed by both parties.

11. There is always the potential for conflict when a law firm represents more than one client in a transaction, and it is important for the parties to understand your role. As you will be preparing the paperwork for the property division work, any information that you receive from either party that is relevant to the other party’s interests must be passed on to that other party. It is imperative that you remain neutral and act in the best interests of both parties. If a conflict arises, you will not be able to continue to act for either one with respect to the property division work, and this must be made clear in your retainer agreement.

### III. The New Triggering Event: Separation Date and Entitlement to Assets

12. The old *FR*A contained a “deferred community property regime,” which meant that during a parties’ marriage, each spouse’s asset was his or her own, to do with what they chose to do, such as create tax plans or estate plans. However, upon the happening of a “triggering event,” each spouse was vested with an undivided one-half interest in family assets as a tenant in common. A family asset was characterized under the *FR*A by how it was used, and in a long or traditional marriage a private corporation owned by one spouse was regularly found to be a family asset as a result of the other spouse’s indirect contribution toward the asset. Under the new *FL*A, how an asset was used during the marriage is no longer determinative.

13. Under the old legislation, the triggering event was the first of a separation agreement, a divorce, or a declaration by the court that there was no prospect of reconciliation. Under s. 81 of the new *FL*A, the “triggering event” is the date of separation. Section 81 reads:

Subject to an agreement or order that provides otherwise and except as set out in this Part and Part 6 [Pension Division],

- (a) spouses are both entitled to family property and responsible for family debt, regardless of their respective use or contribution, and
- (b) on separation, each spouse has a right to an undivided half interest in all family property as a tenant in common, and is equally responsible for family debt.

14. Under the *FR*A, the “triggering event” often took months to occur, and when it finally did there was written proof in the form of a separation agreement or court order. Lawyers did not pay that much attention to the date of separation as it related to the division of assets since the fact of separation did not vest property rights. Now, under the new *FL*A, a “separation” is an extremely important event, and it is sometimes unclear as to whether or not it has occurred since spouses may be separated despite continuing to live in the same residence. Although there is some assistance under ss. 3(4) and 83(1) of the *FL*A, it is recommended that there be evidence of the separation, such as written communication terminating the relationship or retaining counsel.

15. In the scenario set out above, on first glance it would appear each of Sarah and Ron has a right to an undivided half interest in all “family property” as of their date of separation, that being September 1, 2013. However, we must go back to the legislation and the two classes of assets identified. “Family property” is essentially everything that is not excluded and includes a share or interest in a corporation. “Excluded property” is anything that either spouse brought into the relationship (s. 85(1)(a)). Therefore, does the fact that Ron incorporated his companies prior to the date of cohabitation mean that Sarah has no interest in these assets?

16. Under s. 84(1)(g) of the *FL*A, the definition of “Family property” is broadened to include the amount by which the value of “excluded property” has increased since the later of the date the relationship between the spouses began, or the “excluded property” was acquired. Hence, the growth of the companies that accrued during the relationship is shared equally between the parties on separation.

### IV. Valuation of Assets and Excluded Property

17. The old legislation was silent on valuation issues, although case law developed requiring family assets to be valued no earlier than the triggering event, and if an asset had changed in value between the triggering event and the trial date, the trial date was the date that had to be used. Value meant “fair market value.”

18. The new *FL*A has specific valuation provisions. Section 87 of the *FL*A reads:

Unless an agreement or order provides otherwise and except in relation to a benefit under a pension plan,

- (a) the value of family property must be based on its fair market value, and
- (b) the value of family property and family debt must be determined as of the date
  - (i) an agreement dividing the family property and family debt is made, or

- (ii) of the hearing before the court respecting the division of property and family debt.

19. Despite the foregoing definition under the new legislation, there may be disputes involving valuation. Simply stated, in order to value “family property,” which includes dividing the growth of “excluded property” equally, we need to know its value at two points in time—the date when the relationship began (1988), and the date that it ended (September 2013). Unless there is evidence about the value of the companies in 1988, this may prove to be a difficult task.

20. It is now recommended that spouses entering marriage or common law relationships make domestic contracts which set out the value of their respective assets at that date. If a spouse does not wish to enter into a domestic contract, they should at the very least be encouraged to obtain a valuation of their business assets, in addition to simply making copies of banking and investment statements as at the date of cohabitation.

## V. Latent and Distributive Taxes, and Butterfly Transactions

21. The old *FRA* was silent as to how to deal with latent taxes. Case law developed to fill this vacuum. The new *FLA* in large part codifies the existing *FRA* case law, and is not likely to change its substance or practical application. “Butterfly transactions” will remain a useful settlement tool for spouses with shares in closely-held corporations to divide the value of such corporations while deferring latent tax.

22. Latent taxes arise in family law proceedings as a valuation issue in the division of assets between the parties. The question is whether, in putting values on the assets to be divided between the spouses, latent taxes should be taken into account as a deduction from value. Common examples of situations where this issue arises are:

- (a) A recreational or investment property that has increased in value over the course of the relationship. Here the issue is latent capital gains tax on the increase in value of the property that will not be covered by a principal residence exemption.
- (b) Stock options that are “in the money.” Here the issue is latent income tax on the net proceeds that will be realized upon exercise of the options.
- (c) Most commonly, shares in a closely-held corporation. Here the issue is the latent income tax the shareholder will incur in order to draw value (e.g., cash) out of the corporation.

23. The common theme in these examples is that the asset in question, in addition to carrying a latent tax burden, is not easily divided between the parties. One spouse is likely going to keep the asset, for example, the shares in the closely-held company, and the other spouse will keep an equivalent value in other assets, say, the family home. (By contrast, RRSPs also carry latent tax, but valuation issues do not commonly arise because RRSPs are easily divided.) In this circumstance, should a latent tax discount be applied to the tax-laden asset in order to ensure that its value is truly equivalent to the value of the tax-free asset?

24. As mentioned, the old *FRA* was silent on this issue, and indeed was silent on valuation of assets generally. In the vacuum, case law developed providing that latent taxes would not be taken into account in the valuation and division of assets unless a disposition of the asset, or a disposition of the asset was necessary in order to implement a division of property. In both cases, because of the imminent disposition, it would be relatively easy for the parties to provide the court with an estimate of the likely tax burden.

25. The court’s position on this point runs against the relatively common valuation principle that the value of a shareholder’s interest in a company should be calculated net of distributive tax. The court’s concern, running counter to this principle, is to avoid making a finding of fact or a ruling on division of assets based on speculation as to when and how the shareholder will draw value from the company, and accordingly, what the ultimate tax burden will really be.

26. Nevertheless, despite the case law, in practice, reasonable parties will generally allow some discounted latent tax deduction in negotiating these sorts of cases in order to ensure that the division of assets between the parties is fair. However, the case law puts the spouse retaining the tax-laden asset at a disadvantage in this regard in negotiation, knowing that they will carry the burden at trial of establishing that a latent tax discount is appropriate.

27. The new *FLA* does not change this state of affairs, but it does codify the principle expressed by the *FRA* case law. However, it does not do this in the new valuation section of the Act, s. 87, but rather in s. 95, which is the court's jurisdiction to "reapportion" the division of assets off the presumptive 50/50 division provided by s. 81. The relevant excerpts read as follows:

**Equal entitlement and responsibility**

81 Subject to an agreement or order that provides otherwise and except as set out in this Part and Part 6 [Pension Division],

- (a) spouses are both entitled to family property and responsible for family debt, regardless of their respective use or contribution, and
- (b) on separation, each spouse has a right to an undivided half interest in all family property as a tenant in common, and is equally responsible for family debt.

...

**Valuing family property and family debt**

87 Unless an agreement or order provides otherwise and except in relation to a benefit under a pension plan,

- (a) the value of family property must be based on its fair market value, and
- (b) the value of family property and family debt must be determined as of the date
  - (i) an agreement dividing the family property and family debt is made, or
  - (ii) of the hearing before the court respecting the division of property and family debt.

...

**Unequal division by order**

95(1) The Supreme Court may order an unequal division of family property or family debt, or both, if it would be significantly unfair to

- (a) equally divide family property or family debt, or both, or
- (b) divide benefits as required under Part 6 [Pension Division].

(2) For the purposes of subsection (1), the Supreme Court may consider one or more of the following:

...

- (h) a tax liability that may be incurred by a spouse as a result of a transfer or sale of property or as a result of an order;

28. Section 95's equivalent under the old *FRA* was s. 65, which gave the court a limited jurisdiction to depart from the presumptive 50/50 division if the presumptive division would be "unfair." A potentially significant change in the new *FLA* is that it raises the threshold for the court's exercise of this reapportionment jurisdiction to "significantly unfair." The inclusion of a latent tax provision in the new s. 95, rather than in the valuation provisions of s. 87, raises some question as to whether the spouse retaining the tax-laden asset will now have to, in addition to meeting the threshold of showing an imminent or required disposition, demonstrate that it would be significantly unfair not to account for the latent tax in the division of property. The most likely outcome is that courts will conclude that if the imminent disposition or necessity test is met, then the significant unfairness test is met as well.

29. Separating spouses confronting a latent tax issue will continue to need help from their professional advisors to consider and gather evidence regarding the following sorts of questions:

- (a) Calculation of latent tax assuming an immediate disposition; and

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- (b) Expert opinion evidence as to an appropriate discount for latent tax having regard to additional factors suggesting an appropriate time frame in which the latent tax might be incurred, and the manner in which the latent tax might be incurred, such as:
  - (i) The spouse's age and retirement plans; or
  - (ii) The historical pattern of use of the asset and the likely manner of eventual disposition (e.g., will it be a share sale or an asset sale).

30. Lastly regarding latent tax, one way in which spouses may deal with the value of the shares of a closely-held company in a division of property is to conduct a "butterfly transaction" in order to flush out some tax-deferred cash from the existing company to a new company that will be held solely by the other spouse. An example follows, in the context of Ron and Sarah. As Ron and Sarah are married, the butterfly transaction is fairly straightforward from a tax planning perspective (their legally married status allows them to remain 'related parties' and to fit within limited tax exemptions). If Ron and Sarah had instead been common-law spouses, the butterfly transaction would be more difficult to implement (or pose certain tax risks). In other words, although the *FLA* has taken strides to equalize the rights and obligations of married and common-law spouses, the tax rules are not necessarily on par.

31. Assume that once all of Ron and Sarah's significant assets have been valued, Ron and Sarah agree to the following under the terms of their separation:

- (a) Sarah will be entitled to spousal support.
- (b) Although Ron's shares of Nikko Inc. ("Nikko") are attributed considerable value (the majority of which value accrued after 1988), Ron will be permitted to retain 100% of his shares of Nikko. Sarah will resign as director of Nikko Inc. and have no further involvement with the company.
- (c) In consideration for Ron's retention of all of his shares of Nikko, Sarah will receive Ron's 50% interest in their family home.
- (d) Sarah will be removed as a shareholder of Elco Holdings Inc. ("Elco"), such that Ron will retain full ownership of the company following the separation. Sarah will resign as Secretary.
- (e) To equalize Sarah in respect of Ron's retention of Elco, and certain other assets, Sarah will be entitled to a payment of \$3,000,000. The parties have agreed that Sarah will receive this amount gross of personal taxes. That is, the payment will be made by way of a butterfly transaction in which assets are moved from Elco to a holding company owned by Sarah.
- (f) In addition to its commercial property, Elco owns a stock portfolio with a value of \$1,500,000. To make the \$3,000,000 payment to Sarah's holding company, Elco will transfer the stock portfolio and \$1,500,000 in cash to Sarah's holding company. The stock portfolio has some pregnant gains, but between Ron and Sarah it will be transferred to Sarah's holding company on a tax-deferred basis so as to avoid any current taxes. Although Elco does not have \$1,500,000 in ready cash, it is able to take out a mortgage against the commercial property so as to avoid having to sell the property.
- (g) Sarah is advised, and understands, that when she extracts assets from her holding company for personal use the payments will be treated as dividends and will be taxable to her.

32. Ron and Sarah, with the assistance of their family law lawyers, must now decide who will plan and implement the butterfly transactions. For example, will they jointly retain new tax counsel to prepare the tax plan and the documents to implement the butterfly transaction? If yes, will either of them choose to also retain an independent tax advisor to provide a second opinion?

33. Alternatively, will their long-term accountant (who to date has filed the returns for the companies and Sarah and Ron personally) prepare the reorganization plan?<sup>1</sup> If yes, will Sarah, who does not deal with the accountant as regularly as Ron does, wish to receive independent tax advice on the plan?<sup>2</sup> If their usual accountant prepares the plan, will the parties also jointly retain the company's usual corporate solicitors to prepare the documents to implement the transactions?<sup>2</sup> If yes, the documents should be vetted by each party's tax counsel.

34. As a further alternative, the parties could avoid joint representations and simply engage independent tax counsel. In this case, an agreement will be made as to whose counsel generates the plan and drafts the documents, with input from opposing counsel.

35. In all scenarios: (a) correspondence amongst the tax and corporate advisors and the family law lawyers is key, to ensure the steps accord with the terms of agreement between Ron and Sarah; (b) the plan should allocate responsibility for the filing of all required tax elections, to ensure they are not missed; and (c) any lawyer retained by the parties jointly should ensure that Ron and Sarah sign a retainer letter in accordance with the *Code of Professional Conduct for British Columbia*.

36. Acting on the advice of counsel and relying on the valuations of the assets, Ron and Sarah agree to undertake the steps outlined in Exhibit 2 to implement the butterfly transactions, which transactions are structured to avoid triggering any current tax liabilities.<sup>3</sup> Ron and Sarah decide to retain their accountant to prepare the tax plan and handle all tax filings required for the transactions. They also jointly retain Elco's usual corporate solicitors to draft the documents to implement the transactions—and sign an appropriate retainer letter. Sarah retains independent tax counsel to review the plan and the draft documents on her behalf. Ron decides not to retain independent tax counsel. Ron and Sarah agree that they will share equally all professional fees relating to the transactions.

## VI. Tax Liabilities as Family Debts

37. As with latent taxes, the old *FRA* was silent regarding debts, including income tax debts, on relationship breakdown. The only explicit reference to debt was in the reapportionment provisions of s. 65. In this vacuum case law developed establishing that one spouse's income tax liabilities could be recognized and taken into account in the division of assets by reapportioning assets in favour of the spouse with the tax debt. Generally speaking, an income tax liability would be taken into account in this way if it arose during the relationship, or where the income that gave rise to the tax debt had been used for family purposes.

38. The new *FLA* specifically deals with debt at s. 86, and the language will ensure that tax obligations existing at the time of separation are taken into account (unless they pre-dated the relationship). The new language will also extend to cover income tax debts arising after separation, if the income that gave rise to the tax debt was used to maintain "family property" after separation:

### Family debt

86 Family debt includes all financial obligations incurred by a spouse

- (a) during the period beginning when the relationship between the spouses begins and ending when the spouses separate, and
- (b) after the date of separation, if incurred for the purpose of maintaining family property.

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1 In Ron and Sarah's case, their accountant has the tax expertise to prepare the tax plan for the butterfly transactions. This is not always the case, as not all accountants are tax specialists.

2 See note above.

3 Detailed tax analysis and discussion of the tax rules relevant to a butterfly transaction is beyond the scope of this paper. However, some general tax notes are included for context.

39. It is not clear how direct and specific the connection to “maintaining family property” will have to be in order to make an income tax debt arising after separation a shared obligation. As an easy example, it seems clear that tax debt arising on stock options liquidated by one spouse after separation in order to discharge a maturing joint loan would be a family debt. The most difficult examples may be income tax due on recurring income arising after separation where the spouse incurring the tax debt is paying spousal support to a spouse paying carrying costs for the family home out of spousal support. Are the post-separation income tax debts family debts in that circumstance?

## VII. Implications for Discretionary Trusts

40. Under the old *FRA*, the issue of whether or not a spouse’s beneficial interest in a trust was an asset to be taken into account in property division was unsettled. As noted above, the *FRA* dealt with the division of assets on a usage threshold. In the context of a beneficial interest in a trust, a further underlying difficulty was whether the beneficial interest was “property” to be valued and taken into account in the division, or whether it was a mere expectancy with no value. Trust and tax lawyers would generally take the latter view, especially for a beneficial interest in an irrevocable discretionary trust.

41. Based on the usage test, courts from time to time took a different view. Beneficial interests in trusts were found to be “family property” subject to valuation and division in some circumstances, for example:

- (a) If one spouse received regular distributions of income or capital from the trust during the relationship and used those monies for family purposes;
- (b) If the trust owned property that otherwise would meet the family use test if it were held by the beneficiary spouse; or
- (c) If a spouse had disposed of property to a revocable trust.

42. The new *FLA* does clarify this area by making it clear that beneficial interests in a trust will always be taken into account in the division of property, but does so in a peculiar and unexpected way.

43. There are three provisions in the legislation which relate to trusts specifically. Sections 84(2)(f) and 84(3) of the *FLA* deal with scenarios where a spouse has alienated property to a trust but retains some authority to deal with the property, usually as a trustee or a protector of the trust. Note that these sections extend to cover only the property contributed to the trust by the spouse:

### Family property

84(1) Subject to section 85 [*excluded property*], family property is all real property and personal property as follows:

- (a) on the date the spouses separate, property
  - (i) that is owned by at least one spouse, or
  - (ii) in which at least one spouse has a beneficial interest;
- (b) after separation, property
  - (i) acquired by at least one spouse, or
  - (ii) in which at least one spouse acquires a beneficial interest,

that is derived from the property referred to in paragraph (a) or from the disposition of that property.

(2) Without limiting subsection (1), family property includes the following:

- ...
- (f) *property*, other than property to which subsection (3) applies, *that a spouse disposes of after the relationship between the spouses began*, but over which the spouse retains authority, to be exercised alone or with another person, to require its return or to direct its use or further disposition in any way;
- ...

## 2.1.9

(3) Despite subsection (1) of this section and subject to section 85(1)(e), family property includes *that part of trust property contributed by a spouse* to a trust in which

- (a) the spouse is a beneficiary, and has a vested interest in that part of the trust property that is not subject to divestment,
- (b) the spouse has a power to transfer to himself or herself that part of the trust property, or
- (c) the spouse has a power to terminate the trust and, on termination, that part of the trust property reverts to the spouse.

44. The other s. is 85(1)(f) of the *FLA*, which specifically targets beneficial interests in discretionary trusts to which the spouse did not contribute (e.g., usually a child of a parent who has established a family trust with their children as beneficiaries as part of a tax and estate plan). The operative sections are as follows:

### **Family property**

84(1) ...

...

(2) Without limiting subsection (1), family property includes the following:

...

- (g) the amount by which the value of excluded property has increased since the later of the date
  - (i) the relationship between the spouses began, or
  - (ii) the excluded property was acquired.

...

### **Excluded property**

85(1) The following is excluded from family property:

...

- (f) property held in a discretionary trust
  - (i) to which the spouse did not contribute,
  - (ii) of which the spouse is a beneficiary, and
  - (iii) that is settled by a person other than the spouse;

45. The problem with these provisions is that by their combined operation the growth in value of the *trust property itself* is “family property” to be shared equally on relationship breakdown, rather than just the spouse’s beneficial interest.

46. There are a number of significant implications of these provisions:

- (a) They affect a common and widely used tax and estate planning tool, the family trust;
- (b) On the breakdown of a relationship of one of the beneficiaries of such a trust, the spouse without a beneficial interest in the trust will become entitled to half of the increased value of the property held by the discretionary trust, regardless of other beneficiaries of the trust (and, if more than one beneficiary were to experience a relationship breakdown at the same time the claims against the trust property could conceivably exceed the value of the trust property itself); and
- (c) The spouse who does have a beneficial interest in the trust may be required to pay compensation to the other spouse for half of the increased value of the property held by the discretionary trust even though they have no power to obtain a distribution from the trust to make such a payment.

47. In Ron and Sarah’s scenario, Sarah has no guaranteed entitlement under Parentco Trust and has to date not received any discretionary distributions from Parentco Trust. The value of Parentco has increased by \$1,000,000 since the Trust acquired its shares in Parentco in 1999. In addition to Sarah, Sarah’s three siblings and father are discretionary beneficiaries of Parentco Trust. Under a strict reading of the FLA, Sarah

is required to compensate Ron by \$500,000 (being one-half of the increase in value of Parentco during their marriage), even though she has never received anything from the Trust and all of the Trust's assets may in future pass to other family members instead of Sarah. Further, assume that Sarah's brother separates from his spouse the following year—he may also have to compensate his spouse in respect of the increase in value of the Trust's shares in Parentco during his relationship.

48. If you represent a party considering a family trust, or who already has a family trust, there are a few options you may wish to consider for dealing with this change in the law:

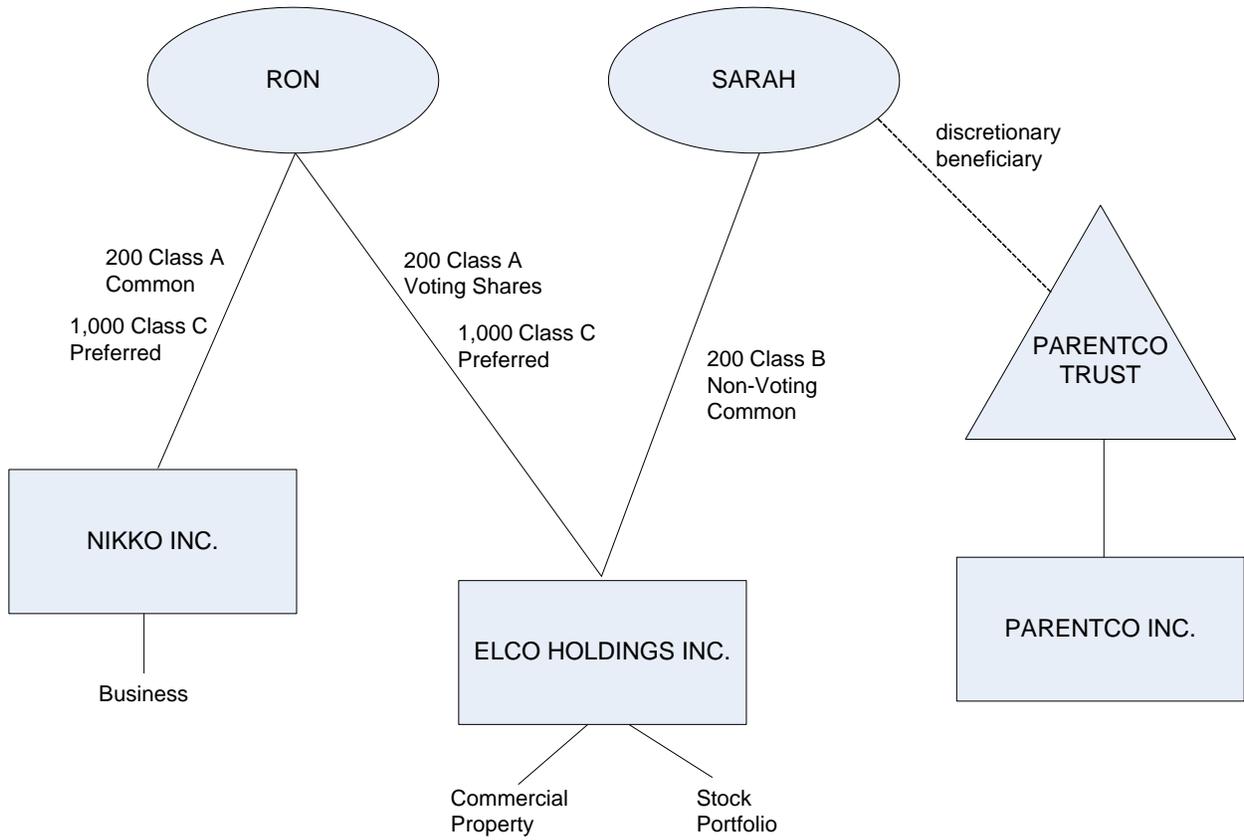
- (a) Use a corporate vehicle for the tax plan instead of a family trust. Provide children with separate classes of non-voting, participating shares in order to retain control over property but be able to distribute income.
- (b) Define beneficiaries to include only “spouses” who have executed a cohabitation or marriage agreement governing or excluding the family trust from the consequences of an eventual breakdown in the relationship.
- (c) Stack discretionary trusts so that the trust property in issue is a beneficial interest in another discretionary trust.

49. If a beneficiary is separating from their spouse and a claim against the discretionary trust is made or expected, an interesting question arises as to whether the trustee may improve the trust's, and the beneficiary's, position by distributing the trust property to other beneficiaries, reducing the value of the trust property to zero. From a family law perspective, the risk is that the claimant and the court may consider this a fraudulent conveyance by the trustee to prejudice the claimant's rights, and the threshold for a fraudulent conveyance claim in BC is very low.

50. The trustee would argue such a claim in the context of the beneficiaries' position *vis a vis* the discretionary trust (e.g., the beneficiary never had anything more than a mere expectancy, the trustee was entitled to distribute the trust property as he or she saw fit, and there was, therefore, no property disposed of as between the separating spouses). However, and this is another illustration of the peculiarity of what the *FLA* has done in this regard, the non-beneficiary family law claimant would argue that the *FLA* has set them up (presumably in order to achieve a family law objective) with a different, and superior, set of rights than the beneficiary *vis a vis* the discretionary trust.

51. Counsel acting for a trustee of a discretionary trust should expect, when a beneficiary suffers a relationship breakdown, that they may be named in the family law action and presented with a claim for injunctive relief to preserve the *status quo*, and that they will be required to produce financial documents regarding the trust property in order to permit a valuation of the increase in value of the trust property over time. Conversely, counsel acting for a non-beneficiary family law claimant will want to claim against the trustee and seek an agreement or order to preserve the *status quo*, as well as document disclosure in order to permit valuation.

### VIII. Exhibit I—Organizational Chart



## IX. Exhibit 2—Summary of Butterfly Plan for Ron and Sarah

The following transactions are completed while Ron and Sarah are still legally married<sup>4</sup>:

- a) Sarah incorporates her holding company (“Sarahco”), as sole director and sole shareholder.
- b) The issued shares of Elco have been collectively valued at \$5,000,000. Ron’s Class C Non-Voting Preferred shares are valued at \$1,000,000. The two classes of common shares held by Ron and Sarah are attributed equal value. Ron transfers to Sarah (on a tax-deferred basis pursuant to subsection 73(1) of the *Income Tax Act* (Canada) (the “ITA”)) 100 of his Class A Voting Common shares. Sarah now holds shares in Elco valued at \$3,000,000.<sup>5</sup>
- c) Sarah transfers her 100 Class A and 200 Class B shares in Elco to Sarahco on a tax-deferred basis pursuant to s. 85(1) of the *ITA*, in exchange for additional shares in Sarahco.
- d) Elco transfers the stock portfolio to Sarahco on a tax-deferred basis pursuant to s. 85(1) of the *ITA*, in exchange for 1,000 Preferred shares in Sarahco with an aggregate redemption value equal to \$1,500,000.<sup>6</sup>
- e) Elco repurchases the 100 Class A and 200 Class B shares owned by Sarahco in exchange for a promissory note in the amount of the fair market value of the shares, being \$3,000,000 (“Note 1”).<sup>7</sup>
- f) The 1,000 Preferred shares of Sarahco owned by Elco are redeemed. The redemption proceeds are paid by the issuance of a promissory note payable from Sarahco to Elco in the amount of \$1,500,000 (“Note 2”).<sup>8</sup>
- g) Sarahco and Elco enter into an agreement whereby they agree to set-off the \$1,500,000 each owes to the other. Elco pays Sarahco \$1,500,000, in cash raised through the mortgage taken out against its commercial property. Note 1 and Note 2 are cancelled.

Attached as Exhibit 3 is the closing agenda for Ron and Sarah’s butterfly transaction.

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4 So as to fit within the rules for ‘related party’ butterfly transactions.

5 Ron and Sarah should file a joint election under the *ITA* to ensure that the spousal attribution rules do not attribute to Ron any income from the shares he transferred to Sarah.

6 This was agreed to by Ron and Sarah, but whether such a transfer occurs on a taxable or a rollover basis may be a contentious issue between the parties. A dispute may arise as whether any beneficial tax accounts, or accrued capital losses, of the relevant companies should be shared by the parties.

7 The repurchase will give rise to a tax-free inter-corporate dividend. Note that Part IV tax may be applicable to the extent that the payor corporation (in this case, Elco) has refundable dividend tax on hand. Tax advisors should be sure to consider the implication of Part IV tax, including circularity issues where the transactions include multiple dividends.

8 See note above.

## **X. Exhibit 3—Division of Property on Separation—Related Party Butterfly Transaction: Sample Closing Agenda**

### **PARTIES**

Elco Holdings Inc.	Elco
Nikko Inc.	Nikko
Sarahco Inc.	Sarahco
Ron Smith	Ron
Sarah Smith	Sarah
ABC Chartered Accountants	Accountants
XYZ Law Firm	Lawyers
<i>Income Tax Act</i> (Canada)	ITA

No.	Description	Responsibility
	<b>INCORPORATION OF SARAHCO</b>	
1.	Incorporation Agreement	Lawyers
2.	Incorporation Application	Lawyers
3.	Articles signed by Sarah as incorporator	Lawyers
4.	Consent to act as director from Sarah	Lawyers
5.	Organizational resolutions (directors/shareholders), with issuance of shares to Sarah	Lawyers
6.	Share certificate for shares in the name of Sarah	Lawyers
7.	Bank account opened for Sarahco	Sarah
8.	Investment account opened for Sarahco	Sarah
	<b>GIFT OF SHARES IN ELCO TO SARAH</b>	
9.	Deed of Gift whereby Ron gifts 100 Class A shares in Elco to Sarah	Lawyers
10.	Share transfer form/stock power of attorney	Lawyers
11.	Director's resolutions of Elco transferring 100 Class A shares in Elco from Ron to Sarah	Lawyers
12.	Old share certificate cancelled and new share certificates issued to Ron and Sarah for Class A shares	Lawyers
13.	Tax election under <i>ITA</i> attribution rules prepared and filed for Ron and Sarah	Accountants
	<b>Section 85(1) ITA TRANSFER OF SHARES IN ELCO BY SARAH</b>	
14.	Section 85(1) Share Purchase and Sale Agreement between Sarah and Sarahco whereby Sarah sells her 100 Class A and 200 Class B shares in Elco to Sarahco in exchange for 900 Common shares of Sarahco	Lawyers

No.	Description	Responsibility
15.	Director's resolutions of Sarahco approving the s. 85(1) Agreement, allotting and issuing 900 Common shares to Sarah	Lawyers
16.	New share certificate in the name of Sarah	Lawyers
17.	Directors' resolutions of Elco transferring shares in Elco from Sarah to Sarahco	Lawyers
18.	Old share certificates cancelled and new share certificates issued in the name of Sarahco	Lawyers
19.	Election form T2057 prepared and filed for Sarah and Sarahco	Accountants
	<b>Section 85(1) ITA TRANSFER OF STOCK PORTFOLIO FROM ELCO TO SARAHCO</b>	
20.	Disclosure by Sarah as interested director, and special resolutions of shareholders of Elco acknowledging disclosure and approving transactions	Lawyers
21.	Section 85(1) Share Purchase and Sale Agreement between Elco and Sarahco whereby Elco sells its stock portfolio to Sarahco in exchange for 1,000 Preferred shares in Sarahco	Lawyers
22.	Directors' resolutions of Elco approving s. 85(1) Agreement	Lawyers
23.	Director's resolutions of Sarahco approving the s. 85(1) Agreement, allotting and issuing 1,000 Preferred shares to Elco and setting redemption amount of Preferred shares equal to value of stock portfolio	Lawyers
24.	New share certificate in the name of Elco	Lawyers
25.	Election form T2057 prepared and filed for Elco and Sarahco	Accountants
26.	Transfer of stock portfolio from Elco to Sarahco	Ron and Sarah, as Directors of Elco
27.	Bare Trust Agreement between Elco and Sarahco in respect of investment assets under stock portfolio (if investments cannot be immediately registered in the name of Sarahco)	Lawyers
	<b>REPURCHASE OF SARAHCO'S SHARES IN ELCO</b>	
28.	Directors' resolutions authorizing repurchase of 100 Class A and 200 Class B shares in Elco held by Sarahco for cancellation and cancelling share certificates	Lawyers
29.	Consent from Sarahco to repurchase	Lawyers
30.	Waiver from Ron in respect of repurchase (if required)	Lawyers
31.	Non-interest bearing demand promissory note issued by Elco to Sarahco in the amount of \$3,000,000	Lawyers
	<b>REDEMPTION OF ELCO'S SHARES IN SARAHCO</b>	
32.	Notice of redemption of 1,000 Preferred shares held by Elco in Sarahco	Lawyers
33.	Consent and waiver from Elco in respect of redemption	Lawyers

No.	Description	Responsibility
34.	Director's resolutions of Sarahco authorizing redemption of 1,000 Preferred shares held by Elco, cancelling shares and cancelling share certificate	Lawyers
35.	Non-interest bearing demand promissory note from Sarahco to Elco in the amount of \$1,500,000	Lawyers
<b>SATISFACTION OF DEBT</b>		
36.	Set-off Agreement between Elco and Sarahco in respect of set-off of cross-debt of \$1,500,000	Lawyers
37.	Directors' resolutions of Elco approving Set-off Agreement and cancelling promissory note payable from Sarahco	Lawyers
38.	Director's resolutions of Sarahco approving Set-off Agreement and cancelling promissory note payable from Elco (following receipt of payment of remainder owing)	Lawyers
39.	Payment of \$1,500,000 in cash from Elco to Sarahco	Ron and Sarah, as Directors of Elco
<b>RESIGNATIONS OF SARAH AS DIRECTOR AND OFFICER</b>		
40.	Resignation of Sarah as director of Nikko	Lawyers
41.	Resolution of shareholder of Nikko reducing number of directors to 1	Lawyers
42.	Notice of Change of Directors filed in respect of Nikko	Lawyers
43.	Resignation of Sarah as director and Secretary of Elco	Lawyers
44.	Resolutions of shareholder of Elco reducing number of directors to 1	Lawyers
45.	Notice of Change of Directors filed in respect of Elco	Lawyers
46.	Resolutions of director of Elco accepting resignation as Secretary and appointing Ron as Secretary (if required)	Lawyers