

# TAXTALK

## CREDITOR PROOFING

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Given the ever-increasing tendency toward the use of litigation in Canada to solve business and family disputes, the overall degree of business asset risk and personal asset risk confronting most owner/managers has dramatically increased.

Creditor proofing involves the protection of both personal and corporate assets from creditors and potential creditors. It is important to arrange one's affairs so that assets owned within a corporate group or among family members are protected as much as possible from creditors at all times.

Creditor proofing generally works best if it is implemented when there are minimal assets and no claims outstanding. The risk that an asset protection plan will be challenged by creditors is greater after the business matures than it is at the start of a business venture.

The purpose of this TaxTalk is to generally outline some of the more common creditor proofing techniques that can be used to protect one's personal and corporate assets. The use of any of these techniques may result in business-related, legal and/or tax consequences that must be fully considered before implementing any particular plan. Business considerations must, of course, be viewed as the first priority. Proper legal and taxation advice should also be obtained in regard to each of the techniques described below.

### LIMITED LIABILITY - MINIMIZATION TECHNIQUES FOR INDIVIDUALS

It is desirable for an individual's or a corporation's business affairs to be structured in a manner that minimizes creditor risk at the outset. Some common examples where this may be possible for **individuals** are as follows:

- (i) An individual's personal liability on a bank loan could be limited through the use of non-recourse loans rather than full recourse loans.
- (ii) An individual could be a limited partner rather than a general partner in a partnership.
- (iii) Where an individual has potential general business liability through a partnership or proprietorship, legal ownership of personal assets such as the personal residence could be transferred to the spouse.
- (iv) Individuals loaning funds to private companies should secure such loans by way of a registered debenture at the time they are made. Consideration should first be given to any impact this would have on both the company's bankers and other creditors. This would apply to owner/managers whose bonuses are often loaned back to the corporation.
- (v) Proprietorships can be incorporated to protect personal assets where business risk is significant.

- (vi) Assets that have high risk associated with their ownership can be segregated from other assets using multiple legal entities, i.e. companies, partnerships, trusts, etc.
- (vii) Life insurance can generally be protected from creditors where a beneficiary of the policy is a spouse, child, grandchild or parent of the insured.
- (viii) An estate freeze may result in a shift of certain assets to other family members, thereby possibly insulating future growth from creditors.
- (ix) Many professionals operate in a limited liability partnership to limit their liability.
- (x) For business operators, it is important to ensure that creditors that have priority (e.g. payroll withholding, GST, PST) are paid on a timely basis. Priority creditors rank ahead of other creditors in the event of insolvency, and in some cases for corporate insolvencies, the directors can be held personally liable for these corporate debts.
- (xi) A trust can be a useful vehicle for asset protection.<sup>1</sup> A trust can be used to separate legal and beneficial ownership of property. This planning can provide protection from creditors without changing control over the use of the property transferred to the trust.

In addition, assets owned by a trust generally do not form part of the settlor's estate. As such, neither the settlor's estate nor his heirs will be subject to the claims of the settlor's creditors upon his/her death.

Beneficiaries of a family trust can also be protected from creditor claims in respect of their interest in the trust if the family trust is irrevocable, the trust is discretionary, and the beneficiaries do not have control of the trust assets, or have the trust property vest to them.<sup>2</sup>

<sup>1</sup> A trust can also provide other ancillary benefits, a discussion of which is beyond the scope of this TaxTalk.

<sup>2</sup> In general, the value of an income or capital interest in a fully discretionary trust is nil. As such, the interests are of no value to

When establishing a trust for the purposes of asset protection, some issues to consider include the jurisdiction in which the trustees and beneficiaries are either based or are resident, the trust law applicable in that jurisdiction, and the physical location of the assets. The asset protective quality of the trust is minimized if all of the above variables are in the home jurisdiction of the settlor, i.e. Canada, but maximized if they are all offshore.

This area of planning is very complex and professional advice should be obtained.

### USE OF SEPARATE CORPORATIONS

The use of separate corporations to carry on different businesses is a basic creditor proofing technique that should always be considered when starting a new business. Separate corporations generally have limited liability, which will help insulate the assets associated with one business from any risks associated with another business.

**The use of separate corporations is also recommended where a business has used accumulated earnings to acquire significant liquid and/or investment assets or perhaps real estate. For example, it is desirable for real estate and/or equipment which is used in the business to be owned by a separate company,<sup>3</sup> rather than be owned by the operating company.** In this manner, the real estate can be protected from direct creditors of the operating business.

If the operating company already owns real estate, it may be possible to separate the real estate by means of a tax deferred corporate re-organization. Where the real estate is owned separate from the operating company, the company owning the real estate would generally charge the operating company a fair market value rent.

potential creditors. However, please note that for Ontario family law purposes, the courts have attached a value for an income or capital interest in a fully discretionary trust to divide matrimonial assets.

<sup>3</sup> i.e., either a sister or a holding company.

This type of arrangement may also provide ancillary tax benefits with regard to the potential for a more rapid deduction of the leasehold improvements<sup>4</sup> incurred by the operating company.

In addition to real estate assets, other liquid assets (such as cash) accumulating in an operating company should be separated from the company to the extent there are accumulated earnings.

For example, term deposits owned by an operating company could be separated and transferred to a holding company by having the operating company pay a tax-deferred dividend to the holding company. In the future, if the operating company requires the funds, the holding company could then loan the funds back by way of a registered debenture, so that, in the event of a business failure, the holding company's right to realize on the loan would precede the rights of any general unsecured creditors of the operating company.<sup>5</sup>

If a holding company does not currently exist, a relatively simple re-organization<sup>6</sup> could take place to establish a holding company and protect the investment assets of the operating company.

### POTENTIAL CHALLENGES

Any creditor protection plan to protect assets is subject to scrutiny and potential challenge. A list of persons who may challenge a plan would include:

- Secured creditors
- Preferred creditors, including landlords
- Canada Revenue Agency (CRA)
- Provincial revenue authorities

<sup>4</sup> Provided that the leasehold improvements are not so substantial that they would constitute an addition to the building of the operating company.

<sup>5</sup> By setting up a holding company structure, it may make it more difficult to access the capital gains exemption on the sale of the operating company in the future. In this case, the potential loss of the exemption must be weighed against the benefits of creditor proofing.

<sup>6</sup> The shareholders of the operating company could transfer their shares to a newly incorporated holding company on a tax-deferred basis, and/or, they may be able to crystallize their capital gains exemptions on the transfer[s].

- Trade creditors
- Suppliers
- Employees

### LEGAL IMPLICATIONS

Certain provisions of the Bankruptcy and Insolvency Act (Canada) and the Fraudulent Conveyances Act (Ontario) may result in certain creditor proofing transactions being set aside. This is especially true where the knowledge of an actual liability or a potential liability (i.e. such as a lawsuit) exists prior to the creditor proofing transaction. It is especially important to arrange one's affairs properly at the outset to avoid this risk.

Where knowledge of such a liability is present prior to implementing any plans to creditor proof the particular individual or corporation, legal advice should be sought with regard to the possible application of the above-noted Acts.

Other bodies of legislation such as the Family Law Act may also apply and would need to be considered. In addition, under Section 160 of the Income Tax Act, CRA is granted rights to challenge transfers of property. This section allows CRA to challenge property transfers from a taxpayer to:

- a spouse or common law partner,
- an individual under the age of 18, **or**
- a non arm's length person,

if the transfers are made when the taxpayer owes debt to CRA.

With respect to real estate purchases, it is important to check for environmental liability. A purchaser of a contaminated site could be held responsible for cleaning up the contamination if they did not properly research the environmental status of the site before buying it. In order to avoid the liability, the purchaser would have to demonstrate that they undertook all appropriate enquiries into the previous ownership and, at the time they acquired the site, they had no knowledge or reason to know or suspect that the site was contaminated.

### INCOME TAX CONSEQUENCES

Any creditor proofing plan or technique may result in significant income tax consequences if the plan is not properly structured. In addition, any loans and/or guarantees made should be properly structured to ensure that favourable tax treatment can be obtained in the event of a loss on either the loan or the guarantee.

Planning in this regard could include charging interest on loans and/or charging a guarantee fee for guarantees. Those individuals and owner/managers who believe that they may be able to reduce their overall creditor risk by utilizing any of the techniques described in this memorandum are invited to contact one of our offices in order that the potential benefits of creditor proofing can be discussed further.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax-planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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