

**ASSET PROTECTION – PLANNING FOR THE OWNER/MANAGER****1.0 OVERVIEW****1.1 Asset Protection - Generally**

No business owner wants to expose business and personal assets to unnecessary risks, especially in trying economic times. By being able to lawfully launch and expand business ventures without unreasonably exposing all of their business and personal assets, entrepreneurs are encouraged to undertake activities which increase employment and incomes generally in the economy. Yet, commercial realities dictate that some level of risk exposure is often required, as lenders generally do not lend without some form of security over their investments.

Because of the dichotomy of interests between owner/managers and creditors, asset protection strategies are essential to business development, and serve an economic good which is very important to the health and growth of the economy.

This paper discusses planning strategies for owner/managers when “asset protection” is the main, or one of the main, concerns or objectives. In particular, this paper will focus on the following five classifications of risk management strategies which act as a useful checklist when considering asset protection issues:

- (a) Arrangement of the ownership of assets so that they are separated from the source or anticipated sources of liability:
  - this is the simplest, and often the fallback strategy of debtors who have not planned ahead.
  - most likely of all strategies to generate an analysis of the potential application of the *Fraudulent Conveyances Act*, the *Assignment and Preferences Act*, and the applicable sections of the *Bankruptcy and Insolvency Act* (when applicable).
  - in the owner/manager context, the approach is also represented by the common practice of transferring and holding key assets such as real estate and intellectual property in entities distinct from the risks of operating entities (discussed further below).
- (b) Diversion of assets so that they are available for use and enjoyment, but unavailable to the claims of creditors, and the converse, diverting the responsibility for certain claims and liabilities to entities with few or no assets:
  - arguably a subset of (a) above.
  - often involves the use of trusts, which divert the ownership of assets to trustees, and away from the claims of the beneficiaries’ creditors.

- partnerships of corporations; limited liability partnerships and other complex structures which establish liability in corporations with few or no assets.
- (c) Acquisition of assets which are exempt from seizure by creditors, including substitution of non-exempt assets for assets which are exempt:
- principally, acquiring insurance products such as segregated funds.
  - these strategies are often considered as part of an owner/manager's estate planning, and in addition to RRSPs, RRIFs, may include planning with Individual Pension Plans.
  - referred to below briefly in the context of RRSPs and RRIFs.
- (d) Risk mitigation strategies:
- adopt better risk mitigation strategies, such as better workplace safety policies, better environmental monitoring, better tax compliance practices, and the like.
  - includes simple and obvious strategies such as ensuring that priority claims, such as source deductions, GST and sales tax remittances, are always paid first and on time.
- (e) Creation of a substitute fund to answer claims and liabilities through the acquisition of insurance:
- planning with insurance is well beyond the scope of this paper, but insurance often provides a creative way to protect assets from potentially large claims, such as product liability claims.
  - tort claims sounding in negligence, including negligent misstatement, expose the owner/manager personally to joint liability with the business, in which case insurance may be the only way to protect the personal assets of the owner/manager if the claim exceeds the business' capacity to pay.

The five classifications of risk management strategies discussed above can be accomplished using a number of vehicles including corporate structures, trusts and other entities. However, in order for these strategies to be successful, the time at which they are implemented may be crucial.

## **2.0 TIMING CONSIDERATIONS AND ETHICS**

Asset protection strategies undertaken by debtors who are insolvent or on the eve of insolvency, are far more likely to be successfully challenged than asset planning strategies and plans undertaken by solvent businesses which are able to generally meet their debts as they become due and there is no real threat of seizure of assets. The *Fraudulent Conveyances Act* bears the

broadest application to this issue, and has the most far-reaching limitations on asset protection.<sup>1</sup> It does not require the transferor to be insolvent or on the eve of insolvency, it applies to any conveyance of real or personal property "...made with intent to defeat, hinder, delay or default creditors..."<sup>2</sup> In practical terms, it is not possible to establish the intent to defeat or hinder creditors when the transferor does not have any creditors. Therefore, consideration of asset protection issues at an early stage when there are few or no claims outstanding is most prudent, and much more likely to be successful and effective.

If the asset protection strategies and plans are not implemented at the start-up of the business, at the very least to be effective they must be undertaken at a time when the business is solvent and able to meet its debts generally as they become due, and at a time when there are no specific claims, the responsibility for which the owner/manager is seeking to avoid.

As a result a somewhat contrarian mindset is needed; asset protection planning should be done when the business is new, or when the business is prosperous and the future looks bright, and the possibility of business failure or insolvency seems remote. There are obvious inflection points at which asset protection should be considered:

- (a) establishment of the business;
- (b) a significant expansion of the business, such as the addition of a new product;
- (c) a significant change in the business, such as a change in location, or the implementation of a new trademark;
- (d) a financing event or major capital expenditure;
- (e) estate planning for the owner/manager.

### **3.0 TYPES OF ASSET PROTECTION STRATEGIES**

#### **3.1 Common Asset Protection Strategies using Corporate Structures**

Asset protection strategies for large companies where management and ownership are separated are quite different than for the owner/manager. For public companies, protection of shareholders' personal assets is not a consideration, and is less likely to be a consideration for the very large private corporation where there is a separation of ownership and management. Also, enterprises with professional management usually (but not necessarily) have greater access to capital and more resources to implement more complex planning structures and a higher level of management sophistication and expertise to properly manage complex structures. What follows are strategies relevant to the owner/manager type business.

##### **(a) Vesting of Key Assets in Different Corporations**

The owner/manager's operating company(ies) should be vested with no more assets than reasonably necessary to carry on the business, usually, just the

---

<sup>1</sup> R.S.O. c. F-29.

<sup>2</sup> *Ibid* at sections 2 and 3.

customer and supplier contracts, inventory and accounts receivable. Other assets necessary to the operation of the business, such as real estate, plant and equipment, and trademarks (and other intellectual property) should be vested in parent or affiliate corporations and leased or licensed to the operating company(ies).

The five classifications of risk management strategies discussed above can be accomplished using a number of Basic Requirements:

- (i) Each entity in the group, including the operating company, should have assets and activities that constitute a separate business – for example, a real property or equipment leasing business, and IP licensing business. However, in any set of circumstances, there is a limit as to how many separate entities a business can be divided into. For example, the establishment of an equipment leasing company, a personal company, an inventory distributor and so on to, form one group carrying on a business as a whole runs a substantial risk that none of them can be said to operate independently and that they are all completely dominated by the parent of the group.
- (ii) Leases and licenses of assets to the operating company must be documented, and be on reasonable commercial terms which are actually observed in practice. It is important that they are not allowed to expire with the passage of time.
- (iii) Lease and rental rates, and other payments, should be market value, and be actually paid, together with all applicable sales taxes and GST.<sup>3</sup>
- (iv) Maintenance of separate books and accounts, separate financial statements.

Since the separate entity(ies) other than the operating entity are passive businesses without employees, director liability should be manageable and consideration can be given to having family members, other than the owner/manager, serve as their directors. This may help establish their independence, but in my view, separate boards are not an essential requirement.

(b) Separation of Different Business Units Into Separate Corporate Entities

The obvious objective is to segregate different businesses and different entities so that business failure or catastrophic losses in one will not bring down all in a house of cards effect. While it is intuitively obvious that separate businesses ought to be in separate entities, it is not so obvious that separate business units carrying on the same or similar businesses may in some circumstances be incorporated and owned separately. Most commonly, different retail locations may be operated as separate entities so that unsuccessful retail locations do not

---

<sup>3</sup> Tax law compliance also requires that dealings between related parties be at fair value.

bring down successful retail locations and can be cash adrift from the corporate group with minimum risk.

As also noted above, it is important that business not be divided into separate entities indiscriminately such that each entity ceases to represent a genuine commercial entity capable of operating independently.

(c) Segregation of Key Liabilities in Separate Entities

Long term liabilities, most commonly a lease, are undertaken by shell companies. The ability to obtain a lease in such an entity without personal guarantees is a function of market conditions generally, as well as a landlord's perception of the tenant and the desirability of obtaining the tenant's occupancy. Some landlords will not lease to a shell company, but will consider a limited term indemnity, or an indemnity limited to the unamortized balance of the landlord's inducement or leasehold improvements.

Basic Requirements:

- (i) A sublease to document the occupancy and use of the premises by the operating company (in compliance with any restrictions on assignment and subletting in the head lease).
- (ii) Instead of back-to-back leases, a mark-up on the sub-lease is appropriate to establish the shell company as having a business, which is also helpful to deter any CRA consideration of the deductibility of the rent under the head lease.
- (iii) The actual payment of rent, with GST, between the operating company and the sub-landlord.
- (iv) Maintenance of separate books and accounts, and separate financial statements.
- (v) Conduct of all communications by the sub-landlord with the head landlord as would be appropriate to a typical landlord / tenant relationship (rather than such communications being undertaken under the name of or through the operating company).

(d) Separation of the Different Businesses or Different Business Units Into Separate Corporate Entities

Usually, business units such as different retail locations which are separately incorporated will be owned by a common holding company, which can act as "banker" for the group. In this way, retained earnings and surplus cash from successful locations can be loaned, on a secured basis, to new start-up locations, or to support struggling locations with the business case merits for investment in them.

It is important however, that business not be divided into separate entities indiscriminately; each corporate entity needs to make business sense and have a business purpose on its own, failing which the group as a whole will be ripe for challenge under the principles as a single group without separate legal existence of each corporate entity within the group.<sup>4</sup>

### 3.2 Capitalization of the Operating Company

#### (a) Capitalization by Secured Debt

The common practice is to capitalize the closely held corporation of the owner/manager with nominal share capital by the issuance of shares for a nominal subscription price. The financial capital which is required from the owner/manager is then advanced from time to time as a shareholder loan. Since the owner/manager's investment by way of unsecured shareholder loans ranks equally with the general creditors of the corporation in the event of business failure, a much preferable approach is to secure the owner/manager's investment in the closely held corporation by way of a general security agreement at the earliest possible time.

Security interests may generally be perfected by registration in the Personal Property Security Registry prior to execution of the security agreement (and prior to any advance or advances of funds).<sup>5</sup> Therefore, a simple, effective and inexpensive strategy at the time of or immediately after incorporation and organization of the corporation is to issue a general security agreement to the owner/manager, and to file a financing statement in the Personal Property Security Registry for a suitably long registration period. Recognizing that the outstanding balance of shareholder loan accounts changes frequently due to fluctuating capital requirements in the business and/or due to tax planning for tax purposes, the general security agreement should be carefully crafted to ensure that, as possible, the obligations secured as defined as broadly as possible to avoid any inadvertent exclusion of any aspect of the shareholder loans from the security.

#### (b) Capitalization of the Operating Company through a Holding Company

A more effective strategy is to interject a holding company between the owner/manager and the operating corporation(s). A general security agreement is then issued by each of the operating companies to the holding company to secure all present and future advances. Because dividends can be declared by a subsidiary to its parent corporation free of income tax or tax on taxable dividends, the holding company enables the owner/manager to securitize the retained earnings of the operating corporations. On a regular basis, at least annually, dividends of the retained earnings may be paid to the holding company, tax free, and then re-loaned back from the holding company to the operating company, secured by a general security agreement. Effectively, what were the retained

---

<sup>4</sup> *De Salaberry Realities Ltd. v. M.N.R.* (1974), 46 D.L.R. (3d) 100 (Fed. TAD.)

<sup>5</sup> *Personal Property Security Act*, R.S.O. 1990, c. P.10

earnings of the operating company are converted to a secured loan ranking in priority to the general creditors (but inevitably subordinated to the company's banker and other more senior lenders).

If there is more than one operating company, in this structure the holding company can essentially act as a banker providing secured loan advances to the different operating entities, on an as required basis, and at all times in priority to the general creditors.

As always, form is important, and the minimum requirements for such a structure include:

- (i) properly enacted dividend resolutions;
- (ii) the actual payment of the dividend to the holding company, and the corresponding advance of funds back to the operating company (which may require the co-operation of the bank);
- (iii) a loan agreement providing for a revolving facility from the holding company to the operating company;
- (iv) a general security agreement and proper registration under the Personal Property Security Act and as otherwise may be required to perfect security under special assets, such as registered trademarks and patents (if there are any).

### **3.3 Asset Protection Using Trusts**

Trusts are a flexible and useful vehicle to transfer the legal and beneficial ownership of property beyond the reach of the settlor's creditors. However, as with any other conveyance, a transfer of property to a trust is subject to challenge under the *Fraudulent Conveyances Act*, or as a settlement under the provisions of the *Bankruptcy and Insolvency Act*.

#### **(a) Inter Vivos Trusts as Asset Protection Trusts**

An inter vivos trust may be settled, the main purpose of which is to protect the assets transferred to the trust from future potential claims against the owner/manager who becomes the settlor of the trust. In such "asset protection trusts", the settlor may retain the right to receive the income of the trust and usually, members of the settlor's family will be the capital beneficiaries. Alternatively, the trustees may have the discretion to sprinkle both income and capital among the settlor's family or any other defined class of beneficiaries. The trust must be irrevocable by the settlor and the owner/manager (as settlor) should not be a trustee, or should be only one of several trustees.

In general, the income tax consequences associated with *inter vivos* trusts is such that use of asset protection trusts may not be attractive for the owner/manager. Some of these tax considerations include:

- (i) the transfer of property to the trust is a disposition for income tax purposes and will therefore trigger the tax liability for capital gains. The asset protection trust is therefore most useful if a trust is settled with cash, or with property in which there are no accrued capital gains. In the “meltdown” of financial markets in 2008/09, portfolio values may be such that an asset protection trust of portfolio investments has become more viable for high net worth owner/managers;
- (ii) income earned by the trust which is not distributed to the beneficiaries in the year is subject to income tax at the top rate for individuals. Therefore, it is not advantageous to accrue income in an asset protection trust, and it is practically necessary to allocate and pay the trust’s net income in each year to one or more of the beneficiaries;
- (iii) the attribution rules in the *Income Tax Act* may apply to attribute income earned by the trust back to the settlor. If the true purpose is asset protection and not income splitting, the asset protection trust is tax neutral to the owner/manager, but in general there will be a strong desire to split income as well; and
- (iv) the trust will be subject to a deemed realization of its capital property pursuant to the 21 year deemed disposition rule, by which a trust is deemed to have disposed of all of its capital property every 21 years with the resulting gain being taxed at the highest margin for individuals at that time. However, at any time before this deemed realization, capital property can be transferred to the capital beneficiaries with a tax deferral.

(b) Testamentary Trusts

When engaging in estate planning, the establishment of trusts which limit the access of one or more of the beneficiaries to the capital of the trust is a very effective way to protect the assets of the estate from falling into the hands of the beneficiaries’ creditors. A typical testamentary trust with an asset protection objective should, as a minimum, have the following characteristics:

- (i) the beneficiary for whom asset protection is desired should not be the trustee, or alternatively should be one of several trustees; and
- (ii) such beneficiary should not have any right to demand a capital distribution from the trust, either by the express terms of the trust, or by operation of law (by application of the principle in *Saunders v Vautier*).

Asset protection using a testamentary trust is mainly useful in the following circumstances:

- (iii) to protect family heirlooms, valuable artistic works or other cherished assets intended to remain in the family for the long run, such as the family cottage, while still permitting such generations to have use, control and enjoyment of such assets (subject to the ultimate application of the rule

against perpetuities). In each set of circumstances, care must be taken to ensure that there is responsibility and accountability for care, custody, repair and maintenance, and if applicable, for sharing of use and enjoyment among beneficiaries;

- (iv) where there is a child or other intended beneficiary known to be unable to manage money, or otherwise has the lifestyle and temperament likely to attract creditor claims;
- (v) the intended beneficiary is the target of substantial litigation, or is subject to existing claims; or
- (vi) the owner/manager is concerned with potential claims against ownership of the business (or its proceeds) arising out of the potential or actual breakdown of an intended beneficiary's marriage.

(c) Offshore Trusts

Settlement of an offshore *inter vivos* trust serves an asset protection purpose by making it extremely difficult, or even impossible under the laws of the jurisdiction in which the trust is established, to attach and seize the trust assets. In the latter regard, many jurisdictions provide protection of trust assets from seizure, but subject to a minimum “look back” period<sup>6</sup>. After this limitation period expires, the trust property is effectively protected against seizure in the offshore jurisdiction.

It is not uncommon in offshore trusts to establish a protector, usually a friend or professional advisor of the settlor who will have the power to advise the professional trustees, and may also have the power to approve distributions, or even to remove or add trustees.

Using offshore trusts for asset protection has many disadvantages, including:

- (i) the trust must be irrevocable by the settlor;
- (ii) the settlor usually loses complete ongoing control over the property of the trust;
- (iii) the trustee does not have any control over investment policy;
- (iv) trustee fees and fees charged by the local jurisdiction where the trust is resident are usually very high.

Offshore trusts for asset protection should not be considered as tax planning vehicles. As a result of a series of very complex and comprehensive amendments to the *Income Tax Act* in recent years, any trust which has a Canadian “resident contributor” is deemed to be resident in Canada and thereby required to pay tax in

---

<sup>6</sup> For example, the limitation period is 2 years in the Bahamas if it is sold.

Canada on the trust's worldwide income. Similarly, the offshore trust will be taxed in Canada on its world-wide income if there is any beneficiary of the trust who is resident in Canada. A resident beneficiary is very broadly defined to enable the Canada Revenue Agency to trace any indirect settlement of beneficial interests back to 'indirect' beneficiaries who reside in Canada.

As a result, an offshore trust should not be looked upon as providing any tax advantage to a Canadian resident and should be considered tax neutral to a Canadian resident in the top tax bracket. As a result, the loss of control over investment policy, and high trustee fees and administration costs associated with offshore trusts, usually rule them out as a viable asset protection strategy.

### 3.4 RRSPs and RRIFs

Like trusts, RRSPs and RRIFs may be a useful means of protecting assets. However, in order to secure assets using RRSPs and RRIFs the following characteristics must be present (at least in Ontario):

- (a) The RRSP must be a locked-in RRSP, meaning that it is established using transfers from registered pension plans and withdrawal of funds by any method, or for any reason other than payment of retirement income in the form of an annuity is specifically prohibited; alternatively.
- (b) The RRSP or RRIF must be sold by an insurance company as part of a life policy in which a spouse (including a same-sex spouse), child, grandchild or parent of the life insured is named as a beneficiary, or in the case of any other beneficiary designation so long as it is an irrevocable designation.

The Supreme Court has stipulated that "funds transferred from an RRSP into a Registered Retirement Income Fund (RRIF) could not be seized by creditors unless the transfer was made for the purpose of defeating the creditors' claim [...] the RRIF was a life insurance policy in effect and therefore was exempt from creditors' claims".<sup>7</sup> Thus, the life insurance products which are RRSP eligible should therefore receive high consideration, but beware also that these products bear substantial fees and management expense ratios well above comparable non-insurance products. Since spouses are considered separate as to property, spousal RRSPs are another viable option to consider.

#### (i) Seizure After Death

When death occurs, creditors realize that their time for getting paid is short, and as well, many debts and obligations crystallize as a result of death. However, creditors have a harder time of it after death if they wish to seize RRSPs or RRIFs. If a beneficiary has been designated in the RRSP or RRIF, the Courts in Ontario have ruled that the deceased's creditors can not claim against the policy. In effect, the proceeds belong to

---

<sup>7</sup> *Royal Bank of Canada v. North American Life Assurance Company et al.* cited in MacKay LLP Chartered Accountants, "Creditor Proofing: Why and How" at <[www.mackayllp.ca/1161021007.pdf](http://www.mackayllp.ca/1161021007.pdf)>

the designated beneficiary(ies) immediately after the moment of death. However, this is not the case if there is no designated beneficiary. Where there is no designated beneficiary, the RRSP or RRIF becomes payable to the deceased's estate; this itself is a good reason for naming a beneficiary to an RRSP or RRIF.

(ii) In Bankruptcy

As a result of amendments to the federal *Bankruptcy and Insolvency Act* which came into force in July 2008, RRSPs, RRIFs and other registered plans under the *Income Tax Act* (such as Deferred Profit Share Plans) no longer form part of the bankrupt's estate for distribution among creditors, with the exception of contributions during the 12 months before the date of the bankruptcy. Accordingly, RRSPs and RRIFs may be a useful tool to avoid liability to creditors and protect one's personal assets.

## CONCLUSION

There are a number of ways in which the owner manager can minimize exposure to risks. Separating assets from liabilities is one of the most effective ways of minimizing risk, and can be undertaken using a variety of investment vehicles, including corporations, trusts, RRSPs and RRIFs. In order to effectively protect assets from the reach of creditors, owner/managers should engage in asset protection in a timely fashion. If the asset protection strategies are not implemented at the start-up of the business, at the very least to be effective they must be undertaken at a time when the business is solvent and able to meet its debts generally as they become due, and at a time when there are no specific claims, the responsibility for which the owner/manager is seeking to avoid.

**For more information on corporate and commercial matters, contact Wesley Brown or Samantha Chapman at Morrison Brown Sosnovitch LLP, 1 Toronto Street, Suite 910, Toronto, ON M5C 2V6, phone (416) 368-0600 fax (416) 368-6068 email: [wbrown@businesslawyers.com](mailto:wbrown@businesslawyers.com) or [schapman@businesslawyers.com](mailto:schapman@businesslawyers.com).**

Visit our website at [www.businesslawyers.com](http://www.businesslawyers.com)

© Morrison Brown Sosnovitch LLP, 2010 All rights reserved.