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September 29, 2004

PROTECTING AND PREPARING ESTATE FREEZES

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PROTECTING AND PREPARING ESTATE FREEZES
Ian Hull

Background – "The Ground Rules"

A typical estate freeze arrangement is set up whereby a parent transfers to a newly formed corporation all of the shares of an operating company and then elects under Subsection 85(1) of the *Income Tax Act* in order to defer recognition of the gain on the transfer. Consideration must be paid for the transfer and it is usually in the form of preferred shares retractable at the option of the parent for an amount equal to the fair market value of the shares of their operating company prior to transfer.

Typically, where a family business is established and in the process of an estate freeze, parents wishing to income split with minor or adult children commonly are counseled to hold company shares for the children in a trust. While minor children who participate in the equity of the business must necessarily have their interests held in trust, it is also generally advisable to hold the interests of an adult child in trust as well.

Typically, there are two objectives in arranging the participation of children as shareholders in the family business. First of all, to the extent that there is excess revenue available for the payment of dividends, allowing children to become shareholders provides an opportunity for income splitting which would not otherwise be available. Typically, the dividends can be paid to the adult child or to a trust for the children and dividend income is applied to cover expenses such

as private school fees, university tuition, vacation, etc. Secondly, by allowing a trust for children, equity participation in the family business, it may also be possible to double up on the $500,000.00 capital gains exemption in respect of shares in a qualifying small business corporation.

Again, an estate freeze typically provides that all of the future growth, represented by the new common shares, is subscribed for by the children or in trust for the children. Therefore, the interest of the children in future growth, depending on the individual circumstances, may relate to 100% of the future growth in the company. Typically, the trusts for the children normally borrows funds on an arm's length basis to subscribe for the new common shares. Quite often, the new common shares are subscribed for a fairly nominal amount as their value is reflected in the future growth in a company.

Often, an objective of an estate freeze is not only to place future equity in the hands of children, but also to crystallize the parents' $500,000 capital gains exemption as part of the estate freeze process.

As is sometimes the case, the children who have received shares on an estate freeze soon discover that the value of their shares exceeds the fixed redemption value of the parents' voting preference shares taken back at the time of the freeze. At this stage in the growth, the parents and children must get along exceptionally well or the estate freeze itself can be a ticking time bomb, as a power struggle may ensue.

As it is often the case, the parents are trustees of the trust for the children and are of course in a fiduciary relationship. They must understand that the trust property is no longer theirs and that it belongs to the beneficial owners under the trust, being the children. A classic conflict that often arises in this scenario is the difference in role as between the parent as trustee for the trust and the parent as director of the family business. Notwithstanding the fact that the parent often will have retained control of the family business through special voting shares, a parent cannot compel corporate decisions without considering the interests of the beneficiaries under the trust of which the parent is often a trustee.

As a result, it is important that any estate plan which provides for equity participation by the children is carefully considered in the context of the practical realities of the family dynamics that often surface.

Tax Impact of the Estate Freeze

The benefits of an estate freeze are obvious from a tax planning standpoint. One can facilitate income splitting among family members and possibly double up the $500,000 capital gains exemption in respect of qualifying small business corporation shares.

However, often the owner/manager will be most often only closely attentive to the tax advantages associated with the estate freeze and will not consider, and may not be alerted to, the possible pitfalls of effecting such an estate plan. In fact, two

years after the estate plan has been implemented, an owner or manager may be regretting his or her decision.

With appropriate planning, many of the potential problems can be anticipated and avoided.

Estate Freezes – Weaknesses

Since 1995, *inter vivos* trusts are taxed at the top marginal rates and with the elimination of the preferred beneficiary election for all those except for beneficiaries who suffer from mental or physical disability in 1995, it is not generally desirable to accumulate income in trust. Therefore, to ensure that the income of the trust is taxable in the hands of the beneficiary (i.e. income splitting), the income must be considered to be "paid or payable" to the beneficiary in a taxation year. Therefore, the trustee must appropriately document the evidence of the beneficiaries' entitlement. For example by way of a written resolution, a demand promissory note issued to the beneficiary or in the case of minor beneficiaries, notice to the legal guardians of the option of enforcing payment.

Another consideration is the imposition of the 21 year deemed disposition rule pursuant to Section 122 of the *Income Tax Act* which provides for a deemed disposition of trust property at fair market value every 21 years. This rule was amended in 1992 and in 1995, providing for some relief up to January 1, 1999. However, after that date all trusts other than qualifying spousal trusts are subject

to the deemed disposition rule every 21 years. Obviously, if a trust holds property consisting solely of shares in a private company, on the 21st anniversary of the trust, there will be a notional sale of the shares at fair market value. Tax is then payable in respect of any capital gains that has accrued on those shares. Typically, the trust assets are not liquid and therefore tax considerations must be carefully reviewed.

One possibility is to have the trustees roll the trust property out to one or more of the beneficiaries pursuant to Section 107(2) of the *Income Tax Act* prior to the expiration of the 21 year period. The property is then deemed to be disposed by the trust at its adjusted cost base and the beneficiary is considered to have received the property at its adjusted cost base. Capital gain in respect of the property would not be taxable until the beneficiary then disposes of the property. As a result of recent amendments to Section 107(5) of the *Income Tax Act* , the rollover is not available if the beneficiary who is to receive the trust property is a non-resident of Canada.

On-Going Conflicting Roles

Perhaps the most typical pitfall of any administration of a trust in the estate freeze environment is the fact that parents or other family members, agreeing to act as trustees, do not fully understand nor inform themselves of the fiduciary responsibilities of a trustee. Obviously, the trustee must be aware that as a fiduciary, he or she is required to act in the best interests of the beneficiaries when administering the trust property and as is often the case, the trustee will

have several roles. For example, the trustee may be the controlling shareholder, parent and trustee and it is likely that the fiduciary responsibilities of the trustee may conflict with his or her responsibilities and any possible self-dealing of the assets. For example, if one of the trustees also controls the company, he or she will have the ability to determine salaries and bonuses payable. There may be determinations necessary to be made with regard to the discretionary payment of dividends. The conflict that may arise as between the corporate role and the trustee role is obvious. While it may be appropriate to proceed on the strength of the corporate rationale behind paying any salaries and/or bonuses, it may be in direct conflict with the neutral and unbiased role of a trustee.

FLA – Considerations

Another consideration is of course the rights that flow from the protections for the surviving spouse pursuant to the *Family Law Act*. There is of course a limited protection against claims in regard to inherited or gifted property and the income realized on that property. Nonetheless, the exclusion from property for income realized on a trust property may depend on whether or not the beneficiary is married at the date the trust is settled.

Section 4(2) of the *Family Law Act* excludes from net family property family property other than a matrimonial home, that was acquired by gift or inheritance from a third person after the date of marriage.

As is often the case, the beneficiary is not married at the date that the trust is settled and income on the gifted or inherited property on the date of marriage is excluded.

Business Corporation Statutes

The business corporations statutes both federally and throughout the provinces are for the most part a series of checks and balances that provide a mandatory framework of corporate governance.[1]

The following is a list of some of the limits on the individual who created the company and his or her ability to govern generally and therefore may be used as a sword by the common shareholder children:

- Obligation to have audited financial statements;[2]
- To provide audited financial statements to the shareholders;[3]
- To hold annual shareholders meeting;[4]
- The veto of common shareholders (by way of a requirement of class veto) on fundamental changes to the corporation's affairs or structure, including a sale of substantially all assets or amalgamations;[5]
- The directors of the corporation are under an obligation to act in the best interests of the corporation;[6]

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[1] Supra Note 2 at page 53.
[2] C.B.C.A., S. 163. (The consent of all shareholders is required in order to dispense with the audit requirement.)
[3] Ibid. Section 155.
[4] Ibid. Section 133.
[5] Ibid. Section 176.

- The compensation agreements of the corporation and all its officers, directors and shareholders is subject to scrutiny;[7]
- If there is a disgruntle child a buyout by the individual who created the company will involve an insider trade requiring specific confidential facts having material bearing of the value to be disclosed to the child.[8]

In addition to the specific illustrations noted above, the individual who created the corporation and then the gifts to his children will generally be exposed to the scrutiny of the Court by way of winding-up applications and the oppression remedy sections of the relevant business statutes.[9]

Alternatives to Consider

Having reviewed some of the pitfalls of an estate freeze, one should also consider the preventative measures that may be taken in order to ensure that the estate freeze vehicle in fact works.

One suggestion, although unique, is to prepare unanimous shareholders' agreement that would address governance issues and buy-sell considerations, it could also confirm a parent's right to manage and protect the parent from certain steps that can be at law, taken by the majority shareholder. Typically, a unanimous shareholders' agreement of this nature would be entered into as the

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[6] Ibid. Section 122(1). The best interest of the corporation have been judicial held to be the best interest of all of the shareholders "taking no one sectional interest to prevail over the others" See John J. Chapman Supra Note 2 at page 54.
[7] 29 Ibid, s. 120 (7).
[8] See John J. Chapman Supra Note 3 at page 54.
[9] See MacIntosh, "The oppression remedy: Personal or derivative?" (1991), 70 Can. Bar. Rev. 29.

controlling shareholder and the trustees as the owners of the common shares. Thereafter, the children would be required, with the assistance of independent legal advice, to agree to the shareholders' agreement as a condition of receiving a distribution from the trust.

Another suggestion could be to ensure that the trust provides for the shares to be held by the trust and that they are retractable by the company. For example, where the trust provides for a distribution of its shares on attaining a certain age, the shares could be made retractable upon the child's birthday to provide an escape mechanism in the event that the child is, for whatever reason, unsuitable to receive the shares.

One should also consider addressing the future economic needs of the parent at the outset of the estate freeze process to ensure that sufficient assets have been set aside for the sole benefit of the parent. I note that one must be very careful in dealing with this aspect of the estate freeze to ensure that in structuring the trust, the attribution rules under the *Income Tax Act* will not apply. It is essential that the parent not be considered the settlor of the trust and that there be an arm's length trustee in order to prevent an argument that the parent through his or her own influence, compelled the trustees to act in a certain fashion.

In order to deal with potential disruptive claims by an estranged spouse on marriage breakup, the children should consider entering into a domestic contract with their spouses, waiving spousal property rights to gifted and inherited property or to family company shares. Again these agreements should be

supported by independent legal advice. Some consideration should be given to addressing concerns as to future mental incapacity of the controlling shareholder parent and often, it is suggested that the parent execute a Continuing Power of Attorney for the management of the property which appoints a special attorney for such services, leaving the administration of all other assets to the individual's spouse.

As a result of the ability of Ontario residents to prepare multiple wills, and as a result of the fact that probate is not required in order to effect a transfer of private company shares, a typical planning technique is to prepare a separate will to dispose of wills in the private corporation. Typically, the deceased prepares a "primary will" dealing with all other assets and a "secondary will" dealing with the disposition of the shares in private corporations. Probate is not required in respect to the secondary will and therefore probate fees are avoided.

Family Trusts

An alternative Estate planning technique, rather than an Estate freeze directly vesting the common shares in the names of the children, is to create a family trust for the common shares. Essentially, the trust will own the common shares and the owner is usually an individual who created the business and the trustees are often that individual plus trusted advisors.

The following is a list of some of the reasons for this Estate planning tool[10]:

[10] Supra Note 6 at page 67-68.

- The trust mechanism allows unborn children to be beneficiaries and provide equally for all children to share in the growth of the corporation;

- The disposition of income is in the discretion of the trustee;

- Depending on the drafting of the terms of the trust children do not become the true owners of the shares until they have been so directed pursuant to the provisions of the trust;

- Flexibility can be created for the individual who created the business in dealing with the common shares such as the right to vote, sale and pledge to shares;

- New obligations are of course created for the individual who created the business as he or she now becomes the trustee.

CONCLUSION

In Summary, the business litigation aspects of the Estate Freeze can dramatically impact on the potentially friendly and tax driven aspects of this often used estate planning tool. The combination of aggressive civil litigation tactics and the frailties of family dynamics is both complex and often costly if the Estate Freeze becomes subject to review by the courts.

On a balance, while an estate freeze is a useful and important planning tool, it should be considered in the context of the potential pitfalls or weaknesses that arise in any complex estate planning technique.

"EQUALIZING GIFTS IN WILLS"

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EQUALIZING GIFTS IN WILLS

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> "HOTCHPOT: (n.) A mingled mass; a confused mixture; a stew of various ingredients; a hodgepodge."

A testator intending to equally benefit his beneficiaries may wish to take into account benefits given to certain of his beneficiaries during his or her lifetime when dividing up his or her estate. Similarly, a testator who is willing to forgive debts owing by a beneficiary may also wish to have this taken in account so as to ensure fairness amongst his or her beneficiaries.

This objective can be achieved through the use of a "hotchpot" clause.

As stated in *Prittie, Re*,[1]

> As is the case with every hotchpot clause, the direction to take certain gifts to the testator's children into account in dividing the residue of the estate among them is an attempt to achieve equality....

OPERATION

Assume an estate of a deceased having a value of $500,000. The Will provides that the estate is to be divided equally among his three children, and that all prior advances are to be brought into hotchpot. Prior to the death of the deceased, he gave $100,000 to child A. The division of the deceased's estate would be as follows.

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[1] [1940] O.J. No. 29 (Ont. H.C.). See also, *Cosier, Re*, [1897] 1 Ch. 325 (C.A.), as cited in Corina Weigl, "Hotchpot Clauses – A Primer", 4th Annual LSUC Estates and Trusts Forum:

> What is the objective of every hotchpot clause? It is simply to prevent a person to whom a testator has left a share of his estate, and who has been advanced in the testator's lifetime, from obtaining, by the combined effect of the bequest and the advance, more of the testator's property than he intended the legatee should have.

Estate:	$500,000	
Advance brought into hotchpot:	$100,000	
Total:	$600,000	
Share to each child:	$200,000	
Child A to receive:	$100,000	($200,000 less $100,000 already received)
Child B to receive:	$200,000	
Child C to receive:	$200,000	

If not for the operation of the hotchpot clause, or the application of some other legal principal (statutory provisions, presumption of advancement, presumption against double portions, as discussed below), Child A would receive $266,666 (1/3 of $500,000 plus $100,000 advance), while Children B and C would only receive $166,666.

Hotchpot clauses are also effective in equalizing benefits where one child receives an interest in property. For example, a testator may wish to give a cottage to one child, and have this taken into account when distributing the residue of his estate.

Consider, for instance, the estate of a testator with three children. Her estate consists of cash totalling $700,000, and a cottage having a value of $200,000. She wishes to bequeath the cottage to one of her children, and equally benefit the other children. The Will may provide that the residue is to be divided equally, with the value of the cottage being brought into hotchpot.

The distribution, then, would be:

Estate:	$700,000
Cottage brought into hotchpot	$200,000
Total:	$900,000
Nominal Share to each child:	$300,000
Child A to receive:	$100,000 plus cottage
Child B to receive:	$300,000

Child C to receive:	$300,000

Caution should be exercised, however, when considering such a clause. If, in the above example, the value of the cottage was to exceed $350,000, then there would be a shortfall in the residue to satisfy the equal distribution. Provision for a contribution by the child receiving the cottage may have to be made.

For example:

Estate:	$700,000
Cottage brought into hotchpot	$500,000
Total:	$1,200,000
Share to each child:	$400,000
Child A to receive:	Cottage (worth $500,000)
Child B to receive:	$400,000
Child C to receive:	$400,000

As can be seen, there is insufficient cash residue to complete the equalization. In order to result in an equal distribution, Child A would have to pay $33,333 to each of Children B and C. If, in the above-referenced example, the cottage was gifted during the lifetime of the deceased, Child A would not be required to repay the estate, unless the Will provided for this. (If the "advance" was considered a loan, then the child would have to repay the difference.)

Another use of the hotchpot clause is to equalize tax liability. In the above example of the transfer of the cottage, the estate may bear capital gains tax liability. This liability will be shared among the three residual beneficiaries. If however, the intention is that Child A is to pay the capital gains, this can be provided for by having the Will express that the capital gains tax is to be paid out of Child A's share of the estate.

SUBJECT MATTER OF THE CLAUSE

In drafting a functional hotchpot clause, care should be taken in describing what advances, precisely, are to be taken into hotchpot.

The clearest method is to describe the property or advance and ascribe a value in the clause itself. For example, the clause may read:

> As I have already transferred certain property to my daughter, , I direct that my said daughter shall bring into hotchpot, upon the division of the residue of my estate, the sum of $, [and I direct that as my said daughter is entitled under the terms here to a life interest only in her share of such residue, the said sum shall be brought into account not only against my said daughter, but also as against her issue].

Note that if an amount is stipulated, that amount must be brought into hotchpot, even if that amount was not lent or advanced, or if an amount had been repaid prior to death[2]. This possible inequity can be avoided by adding the qualifier "or so much thereof as shall be owing" after stipulating an amount.

Alternatively, the Will may refer to an attached list or ledger of advances.

An issue arises as to whether such a list must pre-exist the Will, or whether a list prepared after the preparation of the Will will be effective.

This issue was considered in *Re Barrett Estate*[3]. There, the testator left a Will which provided that the residue of the estate was to be divided among his three sons equally,

> "...taking into account amounts lent or given to each of my sons as per the attached list by myself or my wife and adjusted to present value at the date of my death using the Consumer Price Index as an inflation factor."

One list was made before the Will was executed, and two other lists were made afterwards. The Court had little difficulty in finding that the pre-Will list was incorporated by reference. With respect to the post-Will lists, the Court relied on the presumption against double portions, also known as the equitable doctrine of ademption by advancement (discussed below) and found that the advances referred to in the post-Will lists should be taken into hotchpot. The Court went on to hold that even in the absence of such a presumption, the evidence

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[2] See *Kelsey (Re)*, [1905]; *Theobald on Wills*, p. 785
[3] [2003], 4 E.T.R. (3d) 163 (Alta. Q.B.)

established that the intention of the testator was that the amounts were to be taken into hotchpot. This evidence consisted of an intention expressed in the Will to adjust the estate to reflect advances, and the fact that the testator replaced the original list as advances were made.

Loans are distinct from advances, and must be repaid, which in effect, brings them into hotchpot. This will be the case even if recovery of the debt is statute barred.[4] However, a loan discharged by bankruptcy may be considered fully discharged. Accordingly, if it is to be considered in hotchpot, the wording of the clause should express this intent, by indicating that the advance is to be taken into account "whether legally constituting a debt or not".

With respect to advances after the date of the Will, the hotchpot clause may cover these by specific wording to that effect.

The value of the advance is determined as of the date of the advance. No interest is payable, unless the will provides to the contrary, or unless interest was within the contemplation of the parties at the time of the advance.[5]

Difficulty can arise where the distribution of the residue and hotchpot clauses are contained in a Will providing for a life interest. An example can be seen in the case of *Re Prittie*[6]. There, the Will provided for a life interest to the testator's spouse, with the residue to the testator's children, after taking any "conveyances, transfers ... and also any gift" from the testator or his spouse to the children into hotchpot. The issue was whether the hotchpot clause applies as of the date of death of the testator or whether gifts made by the surviving spouse during her lifetime and by her Will were to be taken into account as well.

The Court began by noting the testator's intention that his beneficiaries be treated equally. The Court therefore felt that the hotchpot clause would cover any gifts made during the lifetime of the testator, and after his death, during the lifetime of the surviving spouse. The Court went on to conclude that the broad

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[4] *Poole v. Poole* (1871), L.R. 7 Ch. 17; *Rose v. Gould* (1852), 59 E.R. 501; *Jolly (Re)*, [1900] 2 Ch. 616 (C.A.)
[5] *Pearce, Re*, [1946] O.W.N. 444 (Ont. H.C.)
[6] [1940] O.W.N. 28 (Ont. H.C.J.)

language of the hotchpot clause (any "conveyances, transfers ... and also any gift") would include any gift by Will, from the testator or his surviving spouse.

The case of *Re Prittie* is illustrative of the power to compel the "hotchpotting" of property of a third party. Marni Whitaker in her article on hotchpot clauses[7] gives the example of a child receiving his grandfather's cottage, and the child's parents requiring, in their Will, that value of the cottage be brought into hotchpot in the division of the parent's own estate so that the shares of the children will be equalized.

OTHER EQUALIZING PRINCIPALS:

a. Advancement

The presumption of advancement provides that where the testator makes provision in his Will for a child or other person to whom he stands in loco parentis and subsequently advances to such child a sum of money, it is presumed that he did not intend to provide a double portion for such child at the expense of his other children. Under the doctrine of advancement, the recipient of an inter vivos gift does not receive the gift a second time under a testamentary instrument. Feeney describes the equitable doctrine of advancement as amounting to ademption pro tanto. It is sometimes expressed as "the presumption against double portions". [8]

The presumption is rebuttable. Evidence would have to establish that the gift was intended to be in addition to the gift provided for in the Will.

If it is the intention of the deceased, it is possible to expressly exclude the presumption of advancement and the issue of hotchpot. A suggested clause to this effect would read:

> I expressly direct that no child or issue of mine taking any share or interest under the trusts hereof shall be liable to bring into account any sum or sums of money or the value of any property or interest

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[7] Hotchpot Clauses (1993), 12 E.T.J. 7
[8] *Re Bayalf Estate* [2000] 3 W.W.R. 455

> which I have already paid or transferred to or settled on such child or issue or which I may hereinafter pay or transfer to or settle upon such child or issue or for his, her or their benefit.[9]

b. Rule against Double Portions

Akin to the doctrine of advancement, but of more limited application, is the rule against double portions. This rule provides a "presumption that a father or person *in loco parentis* does not intend to provide double portions for his children. If, therefore, he gives a child a legacy or a share of residue by his will and subsequently provides a portion for the child, the gift by will is adeemed either in whole or in part dependent upon the amount of the gift. The doctrine of ademption, however, is only applied against a child in favour of other children and not in favour of a widow or stranger or even in favour of grandchildren"[10].

This presumption is said to apply only to fathers, or to persons who have put themselves *in loco parentis*.[11]

c. Statutory Codification of Hotchpot on an Intestacy

On an intestacy, the concept of bringing advances into "hotchpot" is provided for statutorily.

Section 25 of the *Estates Administration Act* provides as follows:

> **Cases of children advanced by settlement, etc.**
>
> 25. (1) If a child of an intestate has been advanced by the intestate by settlement or portion of real or personal property or both, and the same has been so expressed by the intestate in writing or so acknowledged in writing by the child, the value thereof shall be reckoned, for the purposes of this section only, as part of the real and personal property of the intestate to be distributed under this Act, and if the advancement is equal to or greater than the amount of the share that the child would be entitled to receive of the real and personal property of the intestate, as so reckoned, then the child and his or her descendants shall be excluded

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[9] Sheard, Hull and Fitzpatrick, *Canadian Forms of Wills*, 4th ed. (Toronto, Carswell, 1982) at p. 111

[10] *Armstrong v. Garnett*, [1955] 1 D.L.R. 521, citing *Meinertzagen v. Walters* (1872) LR 7 Ch 670, 41 LJ Ch 801; *In re Heather; Pumpfrey v. Fryer*, [1906] 2 Ch. 230, 75 LJ Ch 568; *In re Dawson; Swainson v. Dawson*, [1919] 1 Ch. 102, 88 LJ Ch 73, and *Fowkes v. Pascoe* (1875) LR 10 Ch 343, 44 LJ Ch 367

[11] *Armstrong v. Garnett*, ibid.

from any share in the real and personal property of the intestate. R.S.O. 1990, c. E.22, s. 25 (1).

If advancement is not equal

(2) If the advancement is less than the share, the child and his or her descendants are entitled to so much only of the real and personal property as is sufficient to make all the shares of the children in the real and personal property and advancement to be equal, as nearly as can be estimated. R.S.O. 1990, c. E.22, s. 25 (2).

Value of property advanced, how estimated

(3) The value of any real or personal property so advanced shall be deemed to be that, if any, which has been acknowledged by the child by an instrument in writing, otherwise the value shall be estimated according to the value of the property when given. R.S.O. 1990, c. E.22, s. 25 (3).

Education, etc., not advancement

(4) The maintaining or educating of, or the giving of money to, a child without a view to a portion or settlement in life shall not be deemed an advancement within the meaning of this Act. R.S.O. 1990, c. E.22, s. 25 (4).

Note that the legislation is of limited application. It applies only to advances to *children*. Caselaw has expanded this to include those claiming through children as well.[12] It only applies to advances expressed in writing, acknowledged by the child in writing. The evidence to establish the advancement must be "forceful, cogent and unequivocal".[13]

If the evidence required to establish the advancement is not found, the legislation deems the advance to not fall within the terms of the Act. That is, the presumption of advancement does not apply. This is to be contrasted to the situation of a testacy, where the common law principals of advancement and the rule against double portions will apply. "Because the Ontario Act, unlike the English statute, requires written acknowledgment for a distribution to be an

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[12] *Re Lewis* (1898), 29 O.R. 609 (Supreme Court of Ontario [High Court of Justice])
[13] *Whitford v. Whitford*, [1942] 1 D.L.R. 721 (S.C.C.)

advancement, it is submitted that there cannot be a presumption of an advancement in Ontario law in situations of an intestacy."[14]

As to the characterization of the advancement, Boyd C. stated in *Hall (Re)*[15] that:

> Under our law an advancement is neither a loan or a debt to be repaid, nor an absolute gift. It is a bestowment of property by a parent on a child on condition that if the donee claims to a share in the intestate estate of the donor, he shall being in this property for the purposes of equal distribution.

In *Hall (Re)*, the court found that the writing produced did not establish an advancement, but rather, a loan.

The value of the property advanced is as set out in the instrument, or as estimated when the property was given. No provision is made for the charging of interest.

Not only is the legislation of limited effect by its terms: there is some question as to whether is of legal effect at all. In Schnurr's *Annotated Ontario Estates Statutes*, the author notes that the section provides that an advancement is, if properly evidenced, brought into hotchpot and "reckoned, for the purposes of this section only, as part of the real and personal property of the intestate to be distributed *under this Act* ...". The author argues that because the *Estates Administration Act* does not provide for distribution, but rather, the *Succession Law Reform Act* does, then the section is of "questionable effect". The author explains that the inconsistency may stem from the fact that when the *Devolution of Estates Act* was repealed, some of its former provisions were incorporated into the *Succession Law Reform Act*, and others into the *Estates Administration Act*.

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[14] See Grozinger, "The Ontario Law of Advancement on an Intestacy", [1993] 12 E.T.J. 396 at p. 402-3.

[15] (1887), 14 O.R. 557 (Ch.) at p. 559

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"GIFTS PER STIRPES" – DRAFTING IT THE SAFE WAY

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Will drafters have traditionally made use of such phrases as "to my issue in equal shares per stirpes". While this remains a convenient means of expressing a complicated means of distribution, incorrect use of the terminology "issue" and "per stirpes" can create contradictory wording and interpretation problems which in turn could lead to litigation and unnecessary costs to the estate.

Even the term "issue" can be open to different interpretations when used on its own. "Issue" *prima facie* means descendants to the remotest degree;[1] however, it is often restricted in meaning, because of the context, to descendants of the first degree.[2]

The rule in *Sibley v. Perry*[3] is that when the word "issue" is used with reference to the parent of that issue, as in a gift "to my brothers and sisters, but if they predecease me leaving issue, then their respective shares shall go to the issue," it means "children".[4] Courts have held, however, that this rule is an arbitrary one and often operates to defeat the testator's intention. As such, it ought to apply only as a last resort, if at all.[5]

While the term "issue" describes a class of beneficiaries, the terms "per capita" or "per stirpes" describe how the estate is to be distributed among the class of beneficiaries.

"Per capita" indicates that the estate is to be distributed "by head" – meaning that one share is to be paid to each beneficiary in the class specified who is alive at the date of distribution. Under a per capita distribution, the share

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[1] *Re Linklater* (1967), 62 W.W.R. 163 (BCCA)
[2] *Fishleigh v. London & Western Trusts Co.* (1930), 39 O.W.N. 1, see also *Bicknell Estate v. McDougall* (1992), 48 E.T.R. 101 (BCSC)
[3] *Sibley v. Perry* (1802), 7 Ves. Jun. 522, 32 E.R. 211
[4] *Re Sinclair*, [1963] 1 O.R. 335 (HC)
[5] *Re Spencer*, [1974] 1 W.W.R. 509 (BCSC)

of a beneficiary who dies before the date of distribution goes to increase the shares payable to the other beneficiaries who are alive at the date of distribution. It does not pass to the descendants of the deceased beneficiary unless the will or applicable legislation provides otherwise.[6]

The phrase "per stirpes" signifies that the estate is to be distributed by "roots" or "by representation" – meaning that one share is to be paid to the representative or representatives of each family or line of descendants. In simplified terms, under a stirpital division, a class of beneficiaries will take the share that their deceased ancestor would have been entitled to receive if he or she had been living. They will do so by right of representation.[7]

The *prima facie* rule is that the beneficiaries take per capita unless the context directs otherwise.[8]

Accordingly, to ensure a full stirpital distribution of an estate, the phrase "per stirpes" should be used in conjunction with a class of beneficiaries that includes descendants of all degrees, such as "issue".

To "Issue Per Stirpes"

As indicated above, "issue" *prima facie* means all descendants. If it is not modified with "per stirpes", a gift to "my issue" will mean all of the descendants – children, grandchildren, great grandchildren and all – are to share in the gift.

The problem is solved by recognizing that a stirpital division implies more than one generation – in short, "issue". Greatest clarity is maintained when "per stirpes" is restricted to use with the word "issue" i.e. my trustees shall divide the residue of my estate among my issue in equal shares per stirpes.

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[6] Carmen S. Theriault, "*Hamal Estate v. Hamal*: Should Will Drafters Abandon the use of "issue per stirpes"? ET&PJ vol. 18, 1999
[7] Theriault supra at p. 128
[8] *Re McNeil* (1959) 43 M.P.R. 357 (Nfld TD)

Usually the phrase "issue per stirpes" is generally clear. However, a will drafter must take care when using it and other phrases that have a precise legal meaning. A series of cases has interpreted the phrase "issue per stirpes" to mean that all the living descendants of the testator were to share. In other words, these cases fused the two terms "issue per stirpes" and "issue per capita" that in past drafting practice had been quite distinct.

For example, the meaning of the expression "issue per stirpes" in a gift in remainder was held at trial not to be confined to children and to the issue of the deceased children without a clear context to displace the ordinary meaning. Thus, it was held that the stirpital reference related not only to the testator's two children, but also to his four grandchildren and one great grandchild, such that the remainder would accordingly have been distributed (the life tenant widow having died) into seven equal shares. Ultimately, the Ontario Court of Appeal reversed this trial decision[9] and determined that the testator's sons formed the stocks.

In *Re Hamel*[10] the deceased left the residue in trust "for my issue alive at my death in equal shares per stirpes". The court was asked to determine whether the testatrix intended the residue to be distributed to her children and the issue of any children who predeceased her or instead whether the residue was to be distributed to her descendants of all degrees who were alive at her death. She died at age 93, leaving 5 children, 13 grandchildren and 33 great grandchildren. The court concluded, on the particular facts, that "per stirpes" should be construed to include all the descendants who were alive at her death in equal shares, appearing to contradict the caselaw interpreting the use of the phrase "to my issue in equal shares per stirpes" and divided the estate of $23,107.22 equally among the 51 descendants of the will maker.

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[9] *Harrington*, unreported, February 21, 1986 (Ont. C. A.). See also two other Ontario decisions, *Re McCormack*, unreported, July 24, 1985 (Ont. H. C.) and *Re Mackey* (1986), 37 A.C.W.S. (2d) 373 (HC) on the meaning of "issue". In *Re Hudson* (1970) 14 D.L.R. (3d) 79 (NSSC) "issue" was confined to grandchildren.

[10] *Re Hamel* (1995) 9 E.T.R. (2d) 315 (BCSC)

Carmen Theriault, in her article "Hamel Estate v. Hamel: Should Will Drafters Abandon the use of Issue Per Stirpes",[1] maintains that this decision does not contradict the significant body of caselaw interpreting the use of the phrase "to my issue in equal shares per stirpes". Rather it is simply another case that turns upon the specific (and contradictory) wording used by the testator, or more likely by the will drafter, and must be taken in context of the wording of the relevant paragraph as a whole. In looking at that paragraph, it seems unlikely that the testatrix could have intended a stirpital distribution. The reference to "the share of each of my issue who shall be living at my death" contradicts a notion of a stirpital distribution and suggests instead that the testatrix intended that all issue alive at her death receive a share. Ultimately, the court concluded that the reference to "the share of each of my issue alive at my death" must be taken as modifying the prior reference to "issue per stirpes".

To "Children Per Stirpes"

On occasion, testators (or will drafters) have unfortunately used the phrase "children per stirpes" or "grandchildren per stirpes" or "to my brother and sister per stirpes". The result is a creation of an interpretation problem since, *prima facie*, the terms "children", "grandchildren" or a named individual and "per stirpes" are contradictory.

"Per stirpes" implies that a gift will not necessarily be restricted to descendants of the first degree. "Children", however, means only descendants of the first degree. Therefore, the term "children per stirpes" is inherently contradictory.

To solve this problem, the court must look at the language of the will, there being no *prima facie* rule of construction that supplies the answer.

The question the court must deal with is whether the testator could have intended to benefit the lineal descendants of children who die before the date of

[1] Estate Trusts and Pensions Journal, vol. 18, 1999

distribution. Did the testator intend the word "children" to include more remote issue? As a result, the court must look to the will as a whole to determine the testator's intentions.

If the words "per stirpes" are to be given their traditional, and technical, meaning, it is obviously essential that more than one stirps, or family, be represented in the description of the beneficiaries in the will. It is for this reason that a gift to children of the testator, or of some other person, in equal shares per stirpes, is a contradiction in terms of the word "children" is to be given its natural- and its primary legal - meaning.[12]

Judges have struggled with these words, and have made every attempt possible to find a meaning for these aberrant formulations in an attempt to prevent intestacy. They do so taking into consideration the presumption of early vesting, which holds that when there is doubt, there is a presumption of early vesting. The courts strive to hold the meaning of the words to mean persons of the first degree of descent only in keeping in accordance with the presumption of early vesting and the presumed intention of the testator. Courts want to lean against divesting in the absence of express or clear words.[13]

In the decision *Re Simpson Estate*[14] the Supreme Court of Canada decided that a gift to the children of a life tenant in equal shares per stirpes was confined to her sons and daughters and was not to be construed as a gift to her issue of any other degree. The court refused to accept that the reference to "per stirpes" required, or justified, a departure from the primary - and ordinary - meaning of "children" as "persons of the first degree of descent".

Essentially, the same construction was adopted by the Supreme Court of Canada in *Re Karkalatos Estate*[15] is where the court held that the addition of the

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[12] *Re Lau Estate*, unreported decision (August 10, 2004) Ontario Superior Court of Justice, Cullity J.
[13] *Strittmatter v. Stephens* (1983), 13 E.T.R. 127 (HCJ)
[14] *Re Simpson Estate*, [1928] S.C.R. 329 (SCC)
[15] *Re Karkalatos; Gettas v. Karavos*, [1962] S.C.R. 390, 34 D.L.R. (2d) 7

words "per stirpes in equal shares" were not effective to enlarge a class of beneficiaries described as "my grandchildren" to including "great grandchildren".

In this case, the testator gave certain property equally to his two daughters for life with remainder "among and between my grandchildren, per stirpes, in equal shares". It was held that the testator wanted to treat the daughters equally, and therefore, also their families. Hence, the stocks or stirps were formed by the daughters, with the result the one child of one daughter took one share, while the three children of the other daughter shared the other.

In another case, the testatrix directed that the residue of her estate be divided "in equal shares per stirpes among the issue of my brothers and sisters, A,B,C and D living at my death". The court held that, as the gift was not to the brothers and sisters, but to their issue, the stocks should be formed by their children. Hence, the twelve living children each took a share and the issue of the three children who predeceased the testatrix took the share of their parents.[16]

However, there are some cases in which courts have given some effect to the words "per stripes" and discerned in such words an intention to enlarge the range of beneficiaries beyond the actual description in the will. In *Strittmatter v. Stephens*[17], the court did so, however, limited the class to the descendants of beneficiaries who died prior to the testatrix so that no violence was done to the presumption in favour of early vesting.

In *Re Clark Estate*[18] the court considered the wording to "each of the children of my son, George Edward Clark, per stirpes". It was held that the share of each such child was absolutely vested on the death of the testatrix so that it would not be divested if such child predeceased the life tenant - another grandchild of the testatrix. The judge stated that he was reluctant to give no meaning to the words

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[16] *Re Montgomery*, [1973] 2 O.R. 92 (HC)
[17] *Strittmatter v. Stephens* (1983), 13 E.T.R. 127 (HC)), see also *Heslop v. Canada Trust Co.* (1994) 6 E.T.R. (2d) 315 (BCSC)
[18] *Re Clark Estate* (1993), 50 E.T.R. 105 (BCSC)

"per stirpes" and as such, he looked hard for anything else in the will that might shed light on the testator's intention.

Recently, Justice Cullity was asked to interpret the phrase "to hold the remaining one share of the residue of my estate in trust for daughter C and to pay the income therefrom... to or for the benefit of my daughter... for the rest of her natural life... and thereafter to divide the said one share, or the amount then remaining equally between my son... and my daughter... *as his or her own property absolutely, in equal shares per stirpes.*" The court was asked to decide whether or not the remainder was vested indefeasibly in the son and daughter at the date of death, or whether the words in equal shares per stirpes altered the gift so that their perspective interests in the remainder would be subject to divestment in favour of their respective children and unborn descendants.[19]

The court ultimately determined that on the death of the mother, the remainder vested indefeasibly in the son and daughter and the unfortunate words "per stirpes" did not alter the absolute gift.

However, a drafter of a will should not hope to rely on such findings by the court to give effect to the intentions of the testator but should take care in the words used to express the desire of the testator.

Drafting Suggestions

In order to avoid such inconsistencies and the requirement of a court interpretation, it has been suggested that solicitors undertake the following practice in using the term "per stirpes":

1. It should not ordinarily be used at all where the primary beneficiaries are to be issue of the first degree. Children should be called children.

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[19] *Re Lau Estate*, unreported decision (August 10, 2004) Ontario Superior Court of Justice, Cullity J.

2. It should be confined to gifts over in the event of the death of a child or other beneficiary – in order to cover the possibility, real but not worth long-winded explication, that a child of a deceased beneficiary might have died survived by children. A reference to "issue per stirpes" is a convenient way of briefly incorporating all of these possibilities.

3. If it is necessary to use the phrase, then it should be defined in the will itself so as not to put either the testator or his draftsman at the mercy of a court of construction.[20]

A suggested clause to use to define it would be as follows:

> Whenever in this Will I have directed a division "per stirpes" among the issue of any person, I intend to designate the children of that person and not his or her remoter issue unless a child of that person is then deceased, in which case I intend that the share to which such deceased child would have been entitled, if living shall in turn be divided equally among his or her children and so on with each representation by a deceased individual at each level by his or her children.[21]

Words such as "alive at my death" or "then living" should not be used in the later part of the disposition when the shares are actually being divided. It may result in some confusion so that "issue per stirpes" is mistakenly interpreted to mean "issue per capita".

Careful use of terminology by the will drafter will serve to protect the intention of the testator and avoid costs of an interpretation proceeding.

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[20] "Some Problems in Interpretation in Drafting of Wills" in Estates and Trusts for the General Practitioner: New Developments (Toronto, Ontario: The Law Society of Upper Canada, 1992)
[21] Robyn Solnik LL.B., Drafting Wills in Ontario: A Lawyer's Practical Guide, CCH Canadian Limited: 2003.