Financial Planning

Family Business Succession Planning

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When is the Right Time to Plan for a Transition?

When discussing financial planning this question comes up frequently, "When is the *right* time for our clients to begin the planning discussion?" As we all know there is no "right" time. Planning should begin early and often and when possible, proactively.

We've all heard stories of people we know who wait until a "significant event" occurs before formalizing plans (death of a spouse, a birth of a child, a serious illness, marriage, retirement etc). Each of these events causes us to pause and consider our future and the futures of those around us. Unfortunately, in some circumstances, our options become very limited, once an event occurs. With a formal planning approach, starting early and involving the professional advice of others, you will have options – options that may not be there after the passing of one of the "events" above.

A financial plan will examine and make recommendations on various topics including, cash flow, debt management, asset allocation, tax minimization, ideal savings strategies, retirement planning and estate planning issues. You may be thinking about a number of these issues today, but have you shared them with your spouse or loved ones? Are your advisors aware of your goals or concerns? Now is the time to explore and formalize your plans.

In this article we talk of a common situation with a typical small business owner in Canada. Planning is not discussed until there is a life event that pushes this issue to the top of the agenda and often, by then, we have missed out on some very important options.

The fact a business owner would not have a personal financial plan seems contradictory as most business people have a business plan. But you can improve the odds of a successful transition into retirement with proper planning. We think you will see from the notes and illustrations that follow, there are some very real benefits, both financial and non-financial, to planning early.

Estate Planning Considerations for Family Business Owners

Effective business succession planning requires a careful balancing of business needs and personal wants. The key for most business owners is to avoid assessing goals in isolation of one another. Owners need to be realistic, and most importantly should strive to keep the relevant family members apprised during the planning process in order to avoid family dissention, and in some extreme cases, litigation.

The following list itemizes some of the common goals business owners hope to accomplish when they consider transitioning their business:

- Accumulate, preserve and pass on their wealth
- Minimize & defer taxes
- Avoid family conflicts and litigation
- Provide funding for any tax liabilities

Most business owners are unaware of the technical complexities of structuring their business transition. Nonetheless, attention and care should be given by the business owner to the structure and processes of the succession plan.

For the most part, a succession plan has many moving parts. It touches upon several diverse and technical issues and requires the use of various professional disciplines, and subject matter experts (legal, accounting, tax and financial planning consultants) to address and facilitate the structure for the transition of the business.

The following is designed to identify some of the tax related issues that should be considered in the formulation of a business planning structure. These will be briefly discussed, followed by a more in-depth look at the cornerstone to an estate plan accompanying a succession plan, the Estate Freeze.

- Available Capital Gains Exemption
- Asset Protection Strategies
- Income Splitting Opportunities
- Wills & Probate Planning Issues
- Other Succession Planning Issues
- The Estate Freeze

Available Capital Gains Exemption

- Currently the capital gains exemption is $750,000 for active businesses in Canada.
- Business owners should review the availability of the capital gains exemption as it applies to the shareholders/family members of the family business, or if the capital gains exemption is not available to any or all, you should investigate whether or not the corporation can be purified in order to qualify.
- You may want to consider the use of a family trust structure/strategy to gain multiple use of the capital gains exemption.

Asset Protection Strategies

- Consider if your corporate assets have been effectively protected. Is there a separate holding company for certain assets (land, buildings)?
- You should review with your advisors whether or not a transfer of assets to a spouse, adult child or trust is advisable.

Income Splitting Opportunities

- Be mindful of the various general anti-avoidance rules relating to income splitting among family members (i.e. Attribution Rules, both personal and corporate, Kiddie Tax, Superficial Loss Rules).
- Consider the cost vs. benefit of structuring an income splitting structure within your business succession plan.
- Actively consult with your tax advisor for information on these issues.

Wills & Probate Planning Issues

- Do you and your spouse have a Will? Is it current and in keeping with your personal circumstance?
- Do you have a Will for personal property and one for the business and its assets?
- Consider the potential tax consequences when deciding upon an Executor for both Wills.
- Should you be reviewing spousal rights and the rights of dependents?
- Is a spousal trust the right vehicle to be used for probate planning?
- Consult with your tax advisor regarding probate issues and strategies to reduce probate fees.

- Consider the advantages and disadvantages of Alter Ego Trusts and consider the potential tax implications.
- Family trusts are a powerful planning tool, but they also have limitations. One important limitation is the 21 year deemed disposition rule. Under the tax rules for family trusts, your trust will have a deemed disposition every 21 years. Therefore, if the trust still holds the shares 21 years after the Estate Freeze, the trust may be subject to tax on a capital gain, equal to the gain that has accrued over 21 years.

The Estate Freeze

What is an Estate Freeze?

An Estate Freeze for all intents and purposes is a process whereby capital assets whose continued growth creates escalating tax and succession planning issues are exchanged for similar assets that are fixed in value. It is a fully allowable tax planning strategy.

Why Implement an Estate Freeze?

The following outlined objectives delineate why an Estate Freeze may be to your advantage:

- Firstly, to fix the capital gains tax liability at today's level.
- To pass along accrued asset growth to successors (usually children) in a tax efficient manner (usually by way of a deferral of taxes of the growing assets).
- To potentially facilitate the possibility of a share purchase by an employee or group of employees.
- To ensure that a family business can remain a family business.
- To maximize the access the corporation can have to the Small Business Gains Exemption (SBGE).
- To facilitate the crystallization of the gains for the SB GE.
- For Income Splitting opportunities.
- To structure a stream of dividend income to a retiring shareholder.
- Lastly, to allow for an orderly and systematic redemption of shares following retirement or in the event of disability.

When to Freeze

In order to maximize your deferral, an Estate Freeze should be carried out as soon as possible, as this will limit the growth of your shares and ensure that future growth accrues for the benefit of your children. However, before you freeze, there are two important issues you need to be aware of and should consider.

1) If I Estate Freeze Today

Ask yourself, will this leave enough value for you to live on in the future? Has the timing of your Estate Freeze been properly coordinated with your succession plan? When dealing with the first question, it is generally a good idea to assume that you might not be able to access the future growth of the business to support yourself.

2) Should I Defer the Estate Freeze

For younger aged business owners, especially with young children, if you're not sure how much wealth you need to keep, it may make more sense to simply defer the freeze until you have a better idea of your future needs. However, you may still want to determine what the eventual tax liability will be, and purchase some life insurance to cover the projected liability (see Susan Forint's Article "The Role of Insurance in Family Business Succession").

This tax liability can be artificially modelled now by engaging the financial planning process. Consult with your ScotiaMcLeod advisor for further information and details.

Use of a Partial Estate Freeze

When you freeze, there is absolutely no requirement that forces you to give up all of your common shares. Therefore, you can choose to freeze only a portion of your holdings. This will allow growth to start accruing for the benefit of your children while allowing you to retain an interest in future growth for yourself.

That is, if you're sure you won't need all of the expected future growth in the business for yourself, but you still aren't ready to give up all of the growth today, a partial freeze may be right decision for you.

A partial freeze can also allow you to multiply the availability of capital gains exemptions, should you decide to sell the business. Where a family trust holds common shares, the gain arising from these shares can be allocated by the trust to your children. Your children will then be eligible to offset some or all of the gain with a capital gain exemption claim.

Example of an Estate Freeze

There are several methodologies available whereby the owner of a business could achieve the aforementioned objectives. However, for sake of simplicity, we will delineate the most common method of practice, a Section 85 Rollover.

The following hypothetical situation illustrates the mechanics at play:

Assume that "Bob Co." is owned 100% by Bob. At the age of 60, Bob is considering an Estate Freeze in order to defer taxes and facilitate business succession.

In this particular case, Bob decides to do a partial freeze and transfer 50% of the growth in value of Bob Co. to his son and daughter, while passing on the remaining 25% to his spouse and 25% to himself.

Step 1

Bob incorporates a holding company, "Hold Co.", and issues 25% (each) of the common shares all with nominal value (Hold Co. has no assets and no income) to each of the above-mentioned family members.

Step 2

Bob then transfers his common shares of Bob Co. to Hold Co. in exchange for preferred shares.

The Result:

The "Rollover Provision" of Section 85 of the *Income Tax Act* will allow this transfer to occur tax-free, so long as the value of the Hold Co. preferred shares is equal to the value of the common shares of Bob Co. Furthermore, the Adjusted Cost Base (ACB) of the preferred shares should be equal to the ACB of the Bob Co. common shares.

Then Bob arranges for the preferred shares he receives from Hold Co. to have a Fair Market Value (FMV) of $500,000 and an ACB of $500,000 (they are redeemable) and Bob could demand that they be redeemed for $500,000 (they are retractable). As a result, any future increase in the value of Bob Co., which is owned by Hold Co., will be reflected in the common shares of Hold Co.

Please refer to the following to gain an understanding of the valuation at play.

Duration	Value of Bob Co.	Value of Hold Co.	Preferreds Value of Hold Co.
5 Years	$750,000	$500,000	$250,000
10 Years	$1,500,000	$500,000	$1,000,000
20 Years	$5,000,000	$500,000	$4,500,000

Within the above-noted example, the value of the Hold Co. common shares will be divided equally among Bob and his wife, and the two children.

Coordination with your Succession Plan

For an effective Estate Freeze, your children have to own at least some of the common shares of your company, either directly or through a trust. But, depending on your succession plan, you may want your successor to have a greater interest in the business than other children who will not be active. Consequently, you and your external advisors and subject matter experts will need to consider this when planning for an Estate Freeze.

This issue (along with many others) highlights why planning today is so important for tomorrow. A successful estate plan brings together technical planning with diligent and diplomatic decision makers for the purpose of meeting your needs and goals.

Sources:

BDO Dunwoody “Estate Planning Considerations for Family Business Owners”

CCH Carswell “Tax and Family Business Sucession Planning”