

Business Succession Planning-a case study

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Agenda

- Succession Plan Case Study
- Issues of Parents
 - Estate Freeze
 - Wills
 - Shareholder Agreements
 - Insurance for tax and estate equalization

Case Study Facts

- **Tom and Sophie – late 50's**
- **3 adult children, Diane, Cathy & Derek**
- **Diane and Cathy both involved in the family business**
- **Derek- problem child - Sophie protects**
- **Three companies:**
 - Opco \$10M
 - Realco \$ 2M
 - Shipco \$ 5M

Case Study Facts

- Tom and Sophie own 100% of Opco
- Tom, Sophie and children own Realco
- Tom owns 75% of Shipco
- Brother in law, Jim owns 25%
- Non-family member, Joel, Sales manager of Opco and integral to business

Tom & Sophie



Issues:

Structure and Share Ownership

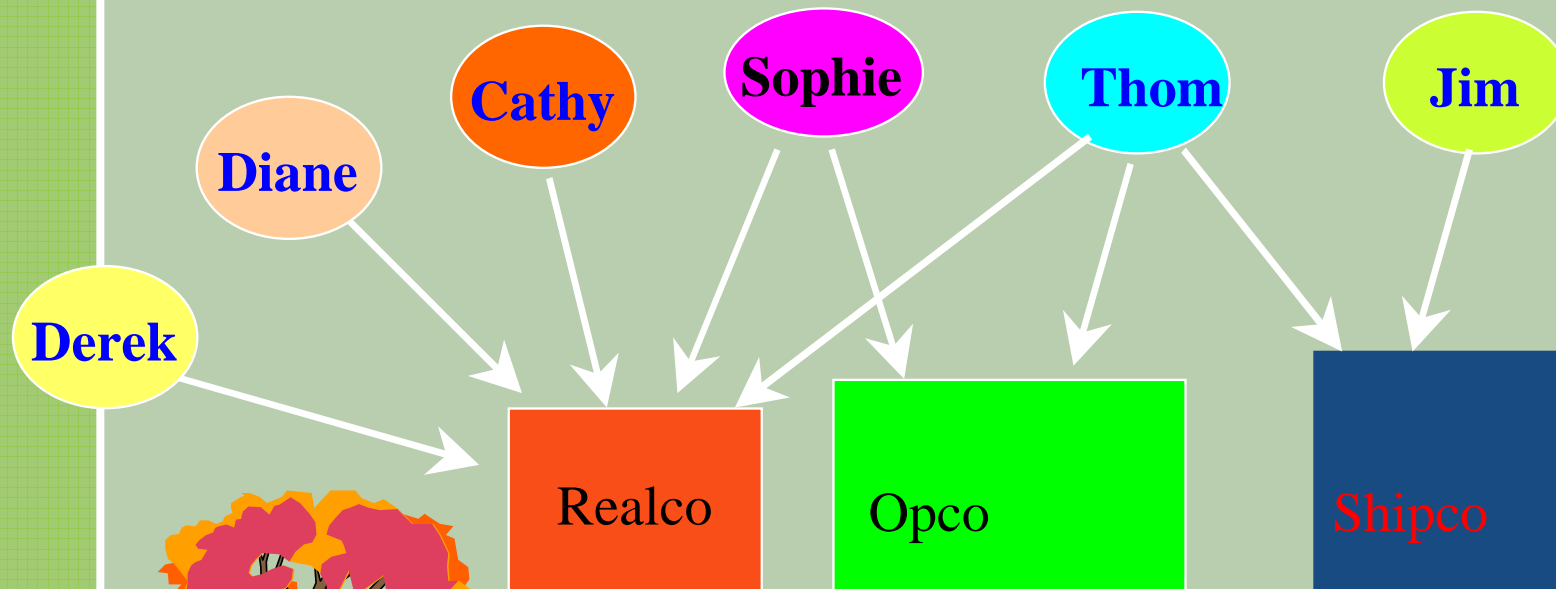
- Do we need an estate freeze?

Do we need a shareholder agreement?

What should our wills say?

Do we need life insurance?

Current Ownership Structure



NET WORTH FOR TOM AND SOPHIE

Personal residences	\$ 1,000,000
Registered investments	325,000
Non-registered investments	300,000
Shares of three companies	14,750,000
Shareholder loans	<u>1,000,000</u>
	<u>\$17,375,000</u>

Business represents 85% of estate value



Estate Freezes

- Caps the value of the shares
- Caps and possibly reduces the ultimate estate tax liability
- Transfers new growth to next generation

Two Common Methods

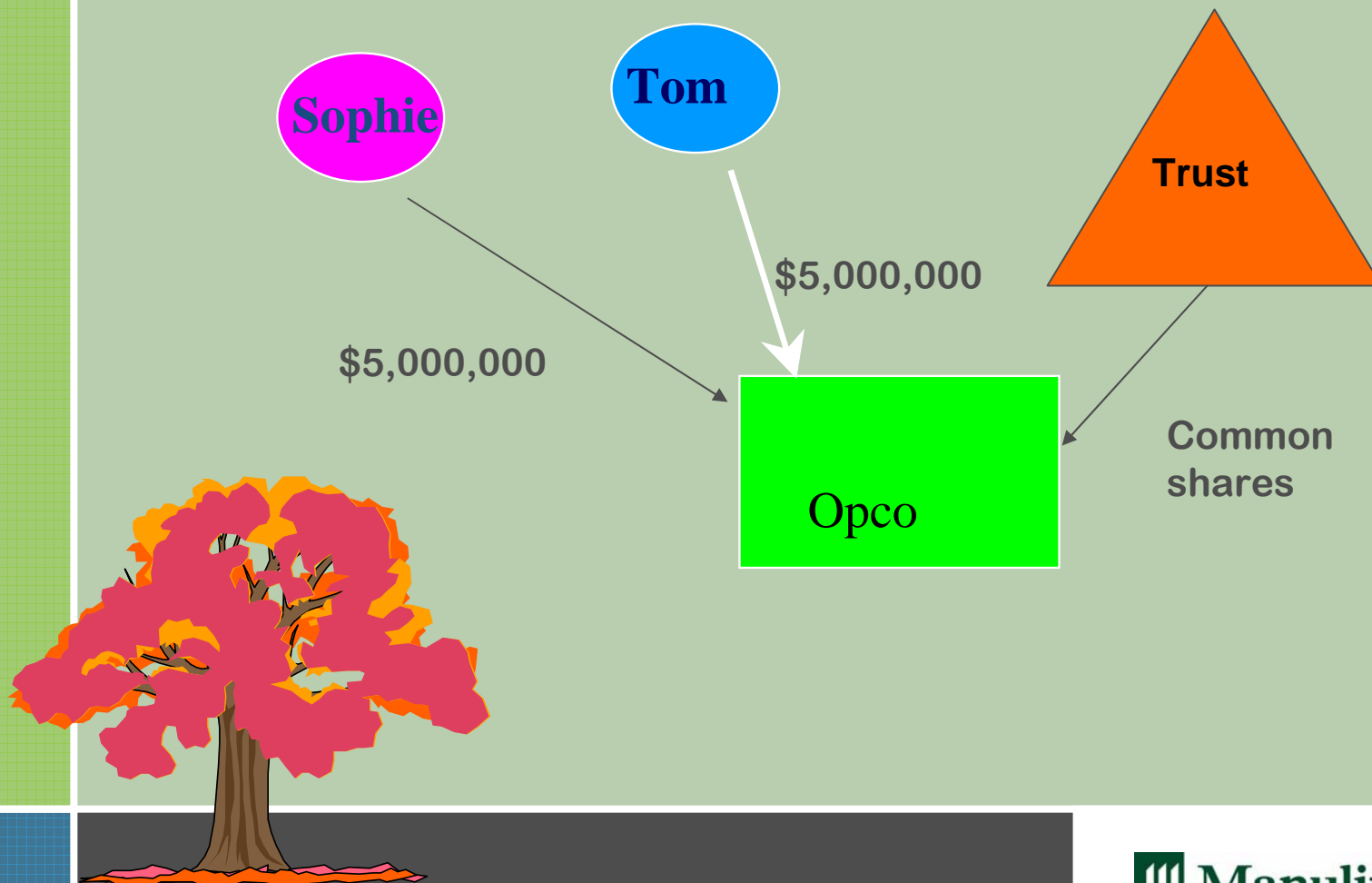
Internal Freeze

Holding Company Freeze

Internal Freeze

- **Exchange of growth shares for fixed-value shares**
- **Common for preferred**
- **Participating for non-participating**
- **Various sections of the ITA Sections 51, 85, 86**
- **Tax-deferred exchange**
- **Issue common shares to Family Trust**

Internal Freeze

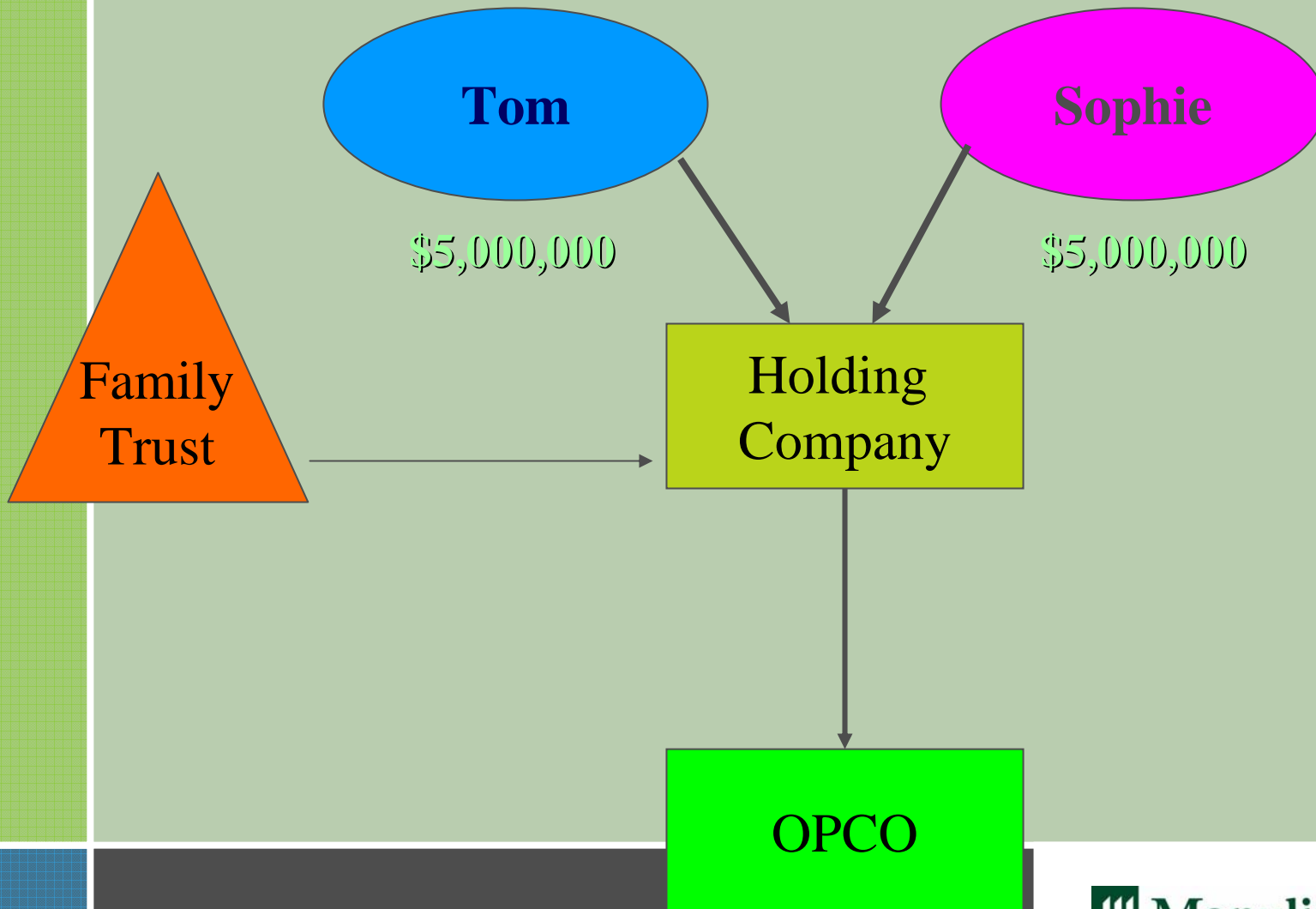


Holding Company Freeze

- **Incorporate Holdco**
- **Issue common shares to Family Trust**
- **Sophie & Tom transfer shares of Opco to Holdco**
- **Receive frozen value shares of Holdco as consideration**
- **Section 85 Election**



Holding Company Freeze



Frozen Shares

- **High redemption amount & low stated capital**
- **Redemption results in deemed dividend**
- **CRA requires them to have value**
- **Cumulative dividend paid on redemption amount OR**
- **Retraction feature (redemption at option of holder)**

Tom's Concerns

- **Ongoing control of company**
- **Ownership of growth shares**
- **Maximum flexibility**



Control

- **Votes can be held by the frozen shares**
- **Number reduced as shares are redeemed**
- **Issue class of voting, non-participating shares**
- **Control with no value (?)**
- **Future control**

Future Growth

- **Use of discretionary Family Trust**
- **Tom and Sophie as Trustees**
- **Include all children, including Derek**
- **Include grandchildren**
- **Include Joel?**
- **Include company owned by Tom**
- **Sophie: Content with structure**
- **Tom: Content with flexibility**

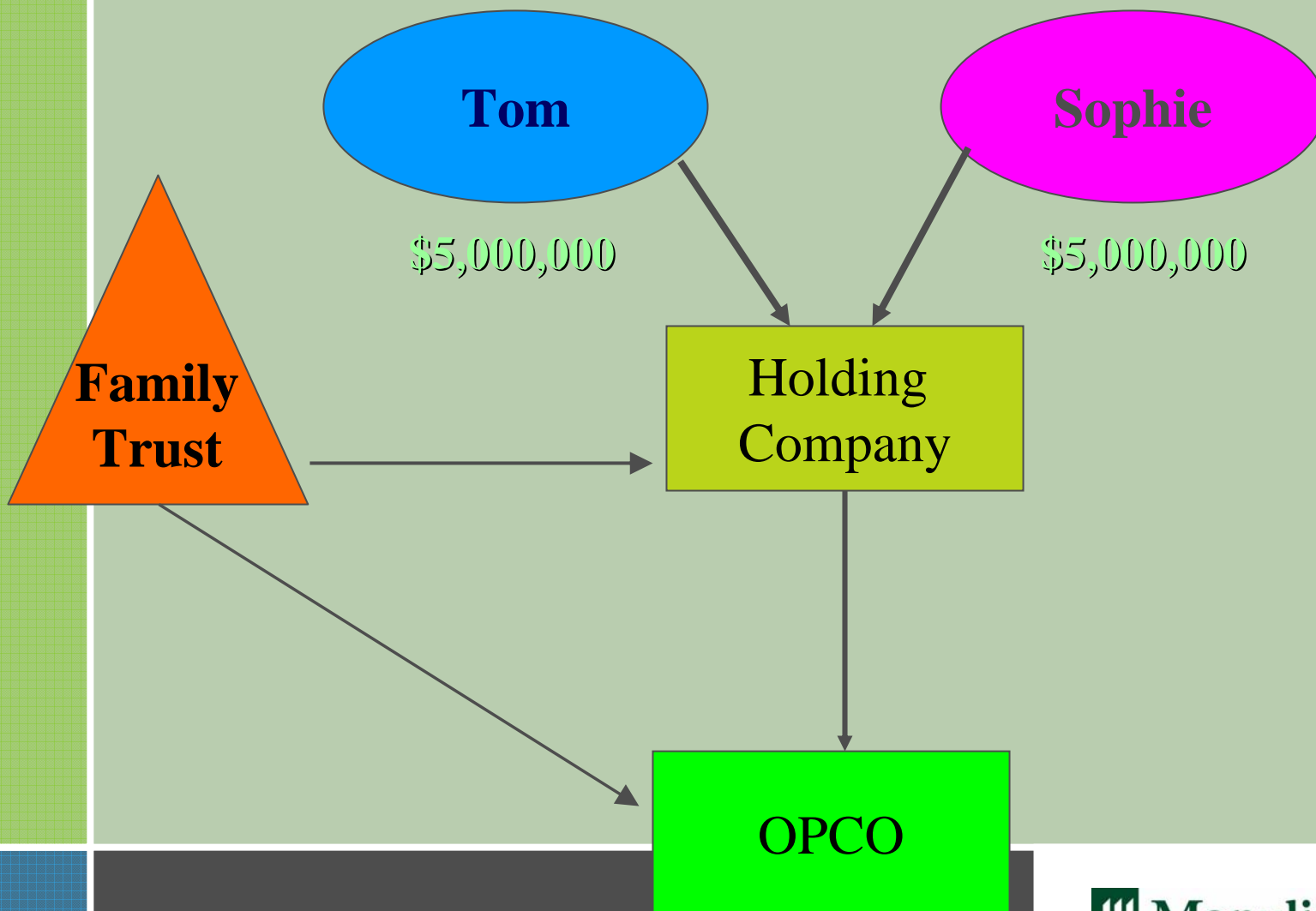
Frozen Value Shares

- Retractable at option of holder
- Retraction allows Tom& Sophie to receive retirement income
- Preferred to a regular dividend as it cancels share
- Reduces estate tax liability
- “Wasting away” freeze
- Watch retraction feature when shares transferred to beneficiaries

Sale to Third Party

- **Ensure structure provides flexibility for sale of Opco shares**
- **Potential for at least \$3.75M of capital gains exemption (Tom, Sophie & kids)**
- **“2-tier” freeze: Family Trust also owns shares of Opco**

“2-Tier” Freeze



Discretionary Family Trust

- **Delays decision on ownership of growth shares**
- **Income splitting: Adult grandchildren**
- **Protection from children's creditors(?)**
- **Co-ordinate with Tom & Sophie's wills**
- **Replacement Trustees; distribution of shares**
- **Decision in 21 years**
- **Allows for decision on freeze itself**

WILLS

- **Should be written as if testator will die tomorrow**
 - shareholders agreement can take years to finalize
 - Will should be in place as back up to agreement
- **Can be changed any number of times**
- **Need no consent of other parties to change will**

WILLS

- Should be reviewed every 5 years
- Should consider tax implications regarding distribution of assets
- Should be FIRST piece of puzzle
- Should be LAST piece of puzzle



Primary Objectives Of Will

- **Equalization between children**
- **Maintain control over distribution of assets**
- **Back up for shareholders agreements**
- **Tax preferred distribution of assets**



Mirror/Reciprocal Wills

- **Tom and Sophie have interest in most assets**
- **Never know who will die first**
- **Both need wills**
- **Wills may not look the same**
 - Might reflect Tom/Sophie's different abilities
 - Might reflect Tom/Sophie's different desires
- **Dual Wills for probate planning**

Choosing Executors/Trustees

- **Should be someone Tom and Sophie trust**
- **Should be someone children can get along with**
- **Should be someone able to administer the assets**
- **If complex, may need more than one**
 - Mechanism for decision-making
- **Need to look at assets first!**



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What have we learned?

- **Shares of 3 companies are most significant asset**
- **Shares of 3 companies have greatest tax consequences at disposition**
- **Tom and Sophie will want to deal with shares first, and possibly use other assets/insurance to equalize.**



Shipco: What do we know?

- **Shipco – attempt to buy out Jim during lifetime or at death**
- **Shareholders agreement may not be completed**
- **Will needs to contemplate transfer of Tom's shares of Shipco at death**
 - Will might need to provide direction to new shareholders

Opco: What do we know?

- **Opco – intended freeze in favour of children**
 - Kids/trust common shares
 - Tom and Sophie pref shares
- **Possible additional Holdco**
- **Will should consider post-mortem freeze in favour of children/trust**



Realco: What do we know?

- **Intended freeze in favour of children/trust**
 - Possible use of separate Holdco
- **Opportunity to use this asset to equalize**
- **Testamentary (Discretionary) Trust for children**
 - Trustees should have discretion to allocate income as well as capital without having to be equal amongst children

So how do we put this all together?

- **Tom and Sophie need to sit down and ask themselves:**
 - Do they know for sure which shares are to go to which children?
 - Do they know for sure which shares are NOT to go to which children?
 - Are they comfortable leaving the decisions to trustees after death?
 - Do they want to equalize?
 - DO THEY WANT THE SAME THINGS FOR THEIR CHILDREN?



What if Tom dies first:

Tom's Concerns

- **General Idea: All to Sophie; gift over to kids**
- **Ensure that Sophie has sufficient income to live on**
- **Ensure that corporations pass to (appropriate) kids at second death in tax effective manner**
- **Ensure that Sophie/children not left with Jim headache**
- **Equalization in some fashion**
 - Retain some control?

What if Tom dies first:

Tom's Concerns

- **Rollover of shares to Sophie:**
 - Tax efficiency
 - Keeps out of hands of children
- **Can Sophie deal with companies directly?**



What if Tom dies first:

Tom's Concerns

- **Ultimate gift over to children:**
- **Which kids should take over which businesses**
 - Should it be based on ability?
 - Should it be based on equality of gifts?
 - Should it be based on deservedness?
 - What to do with Derek?

What if Tom dies first:

One Solution

- **Testamentary Spousal trust allows Tom to defer taxes until last death**
- **Allows Tom to appoint trustee(s) to maintain control over companies during Sophie's lifetime**
 - Not limited by 21 year issues
- **Provides income to be payable to Sophie to supplement other income she is living on**

What if Tom dies first:

One Solution

- **Encroachment of capital in favour of Sophie**
- **Remaining Capital to children at Sophie's death**
 - Which child receives which shares?
 - When and how many shares are distributed?
- **Terms of allocation could be set out in will;**
- **Trustee(s) could have full discretion as to allocation;**
- **Will could/should contemplate continuing existence of trust after Sophie's death**

Tom's biggest problem

Who are trustees?

- Should be able to manage affairs of corporation
- Should be able to make tough decisions amongst children and Sophie
- Should be respected by children



What if Tom dies first: The hard questions

- **Who knows the business?**
- **Who does Tom trust?**
- **Who has Sophie's interests at heart?**
- **Who has children's interests at heart?**

What if Sophie dies first: Sophie's Concerns

- **All to Tom, remainder to children**
- **No need for Spousal trust to control business**
- **How to deal with Derek?**
 - Sophie thinks Derek should share equally
 - Sophie has no control over Tom's decisions after death
- **Could consider personal Insurance**
- **Insurance trust for benefit of Derek, to dovetail with Tom's decisions at his death**

Shipco

Living buy-out of Jim, if possible

- Consider freeze and serial redemption

Unilateral buy-sell on death

- If Jim dies first, Tom buys Jim's shares
- If Tom dies first, shares stay in family
 - Rollover to Sophie
 - On last-to-die - shares to kids

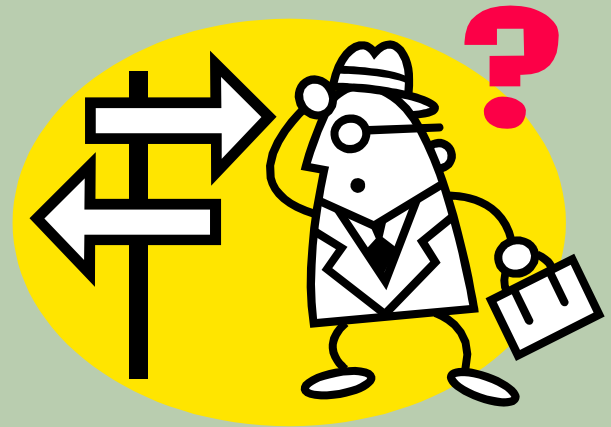
Shareholder Agreement

Management and control

- During Tom's lifetime/involvement
- After death/involvement

Major decisions

- Death/disability/insolvency/marital breakdown
- Financing
- Spouse?
- Next generation?



Life Insurance

What's the Insurance Need?

- Estate tax liability?
- Estate equalization?
- 50% Solution?



Final Taxes

- **Estimated at \$3.0M based on current asset values**
- **Growth of assets?**
- **Other liquidity?**



Estate Equalization

- **Estate value before tax \$17.3**
- **Allocated equally \$ 5.8**
- **Cathy and Diane shares \$14.7**
- **Additional assets needed \$ 4.8**

How much insurance?

Taxes

\$3.0

Equalization

\$4.8

\$ 7.8

=====

Other Insurance Needs?

- Fund shareholders agreement for Shipco to buy back Jim's shares
- Fund shareholders' agreement for the children's shares
- Split-dollar / IRP / Estate Bond for children
- Consider the BVP rider
- Charitable gift



It's Lonely at the Top!

- **Most clients need help in fully understanding**
 - Decisions that need to be made
 - Issues that must be resolved first
- **Planning needs to be flexible**
- **Worst plan: Do nothing!**