The Family Business – Tax Issues & Succession Planning

There are more than 100,000 family businesses in Canada. They employ about half of Canada's labor force and contribute more than 70 percent of the country's GNP. With the baby boomers reaching retirement age, a large number of companies will likely change hands in the coming years. According to TD Waterhouse, just **24 per cent** of small business owners surveyed said they had a succession plan worked out for retirement.

This presentation will provide assistance in gaining a better understanding of the factors that can mean success or failure when deciding upon a succession plan. Small case studies will be utilized to apply the topics. The topics covered include:

- The importance of having a plan
- The planning process (analysis of financial situation, objective setting, implementation & review)
- Tax planning
- Family Farming Business considerations
- Shareholder agreements
- Utilizing Buy/Selling Agreements
- Using Family Trusts for Income Splitting and Estate Planning
- Creditor-proofing when estate planning
- Estate Freezes
- Planning tips (Compensation/Federal Budget 2017)
- Where to get more information

http://www.cbc.ca/news/business/10-surprising-stats-about-small-business-in-canada-1.1083238

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This course focuses on the factors that can mean success or failure when deciding upon a succession plan.

- Small case studies utilized to apply the topics.
- The use of insurance utilized and applied as is estate freezes
- “Estate freeze” is a term used to describe a basic reorganization in which the value of an enterprise is “frozen” in fixed-value preferred shares equal to the fair market value (“FMV”) of the business or holdings at the date of the freeze, allowing the future growth in value of a corporate entity to be attributed to common shares held by others, such as children or a family trust.
- In Canada, Canada Revenue Agency (CRA) Section 51, 85 and 86 are all estate freeze types that can be applied depending on the business type and owner goals.

Tax Planning in the Family Business - Deemed Disposition of Property

- One of the greatest challenges faced by business owners is finding ways to minimize the capital gains tax that will arise on a sale or other type of transfer of ownership.
- Capital gains tax is imposed at the time of death, because of CRA's deemed disposition rule.
- Deemed disposition is used when a person is considered to have disposed of a property, even though a sale did not take place.
- Deemed proceeds of disposition occurs when a person is considered to have received an amount for the disposition of property, even though the person did not actually receive that amount.
- Creates a deemed disposition of certain types of property of the taxpayer immediately before his or her death and consequently triggers the realization of any capital gains that have accrued to date.

Tax planning - the lifetime capital gains exemption (LCGE)

- A tax planning technique that is available to business owners selling shares of their private companies is the lifetime capital gains exemption on the sale of Qualified Small Business Corporation (QSBC) shares (defined in subsection 110.6(1) of the ITA).
- Carry on an active business in Canada; at least 90% of the assets of the company are used in the company
- The exemption generally increases from year to year, indexed for inflation, and equals $835,714 in 2017.
- The corporation whose shares are disposed of must be a Canadian-controlled private corporation ("CCPC")
- More than 50% of the FMV of the corporation's assets must have been used in an active business carried on primarily in Canada throughout the 24-month period immediately before the sale
- The shares must not have been owned by anyone other than the small business owner or someone related to you during the 24-month period immediately before the sale

Compensation Structure for Small Business Owners (Dividends/Salary):

- Dividends have the advantage of being taxed a lower rate than salary, which can result in you paying less personal tax, but lessens the amount of CPP entitled to at retirement.
- Receiving dividends does not allow contribution to an RRSP and eliminates other personal tax deductions (like child care expense).
- Often, a mix of salary and dividends is best, particularly if it assists in ensuring that the corporation does not earn over $500,000. This is because $500,000 is CRA's Small Business Limit. Up to this amount of income, a privately controlled Canadian Corporation (CCPC) pays income tax at a much lower rate than it would on income over this amount (at a tax rate of about 16% depending on which province it operates from).
- So it almost always makes sense to pay enough salary to the owner to reduce the corporate income to this $500,000 level.
- However, depends on the business owner's own personal financial circumstances as well as on what the corporation's predicted income for the year (cash flow).

The capital gains exemption is available for small business corporation shares, farm property, and fishing property, and is reduced by any capital gains exemptions used in 1994 or earlier. Only gains that exceed cumulative net investment loss (CNIL) are eligible for the exemption.

Maximum Capital Gains Exemption Capital Gains Deduction is 50% of Exemption		
Date of Disposition	SBC Shares	Farming/Fishing Property
2017	$835,714	$1,000,000
2016	$824,177	$1,000,000
2015 after Apr 20	813,600	1,000,000
2015 before Apr 21 (1)	813,600	813,600
2014	800,000	800,000

For qualified farm property that is depreciable property you can choose to transfer this to your child at any value between its undepreciated capital cost (UCC) and its FMV.

A transfer of property between family members is generally treated for capital gains tax purposes as if the transfer had been made at fair market value. In the case of appreciated assets, this means triggering a capital gains on which income tax is payable.

Farming businesses are afforded different and far more generous treatment. If property is used in an active farming business (the farm land itself) it is transferred to the spouse, child, grandchild, or great-grandchild of the person carrying on the business, the transfer is generally considered to take place at cost, not fair market value. Thus, no capital gains has to be reported. The capital gain exemption is available to offset any triggered capital gain on the sale of qualified farm property.

For Business Owners - Four possible outcomes

(i.e., through an
Estate Freeze/Trust)

Liquidate the business

- Would you get fair market value
- Would you get any goodwill you have built up
- Will those who owe company money renege on their obligations
- The jobs of the survivors and employees get liquidated as well
- Its more than $ its personal

Sell to a third party

- Would the price reflect fair market value
- Is there are formal agreement in place?
- Will the new shareholder be acceptable to existing stakeholders?
- What happens if stakeholders have different visions?

Heirs join the company (i.e., through an Estate Freeze/Trust)

- Who will inherit the interest?
- Do they have the skills?
- Do they have the same passion?
- Would they be a good fit?
- Will they have different expectations than the surviving shareholders (growth vs. income?)
- What if there is more than one heir?
- 21-year life of trust (mechanics of a future crystallization)?

Buying out heirs with a buy-sell agreement

- Eliminates many of the conflicts associated with the other outcomes
- Most effective way to provide an orderly transfer of ownership
- Reflects views of all owners before the event
- Ensures business continuity
- Heirs can be guaranteed fair price and can buy back in if that is what is desired
- Control over what happens in case of worst case scenario

The importance of having a plan:

- The Financial Planning Standards Council (FPSC) reports that financial planning is more than budgeting, saving or having the perfect investment strategy.
- Financial planning is a process that sets you on a course toward achievement of your personal goals, needs and priorities through the proper management of your financial affairs

Lack of a formal structure is a frequent cause of turmoil

- For family-owned businesses, especially those with multi-generational owners
- legal disputes which often result in very contentious litigation and, ultimately, the dissolution of the business.
- Example:
  - https://www.youtube.com/watch?v=4MG7eAsWPoY
  - Source Security Mutual Life – N.Y.

Family business owners should consider these issues when creating a business succession plan:

- How will a divorce involving one of the owners impact the business?
- If an owner dies, how will his or her interests be distributed?
- What happens when an owner wants out of the business at some point in the future?
- What options or mechanisms will allow the purchase of a deceased member's interest without bankrupting the entire business in the process?
- How will the fair market value of an owner's interest be calculated in the event of a buy-out?

The owner of a family business who is planning to retire should really make three separate but interrelated plans:

- A Retirement Plan: This covers retirement goals (education, travel, sports, arts, business, volunteer work, and hobbies), living arrangements, health management issues, and a budget for retirement.
- An Estate Plan: This covers sources of retirement income, a will, powers of attorney (including a living will), and any trusts are set up to manage assets.
- A Succession Plan. Decisions about who will eventually run the family business and how it will be owned are included here.

A Succession Plan:

- should explain the transition role of the retiring generation.
- The succession plan is most likely to be successful if control is left in the hands of an individual family member.
- This does not necessarily mean majority ownership, just owning a majority of the voting shares.
- The succession plan should be written with clear timelines for transferring control of the business.
- Family business owners are most likely to commit to a succession plan when they are in their fifties.
- Prior to this, they are generally not ready to consider retirement.
- Past their fifties, there seems to be an increasing reluctance to give up power.

So what can families do to help ensure a successful transition?

- The key is to have these discussions early and often, and when possible, involve not only the family, but also important advisors such as your accountant, lawyer and financial planner.
- **Expectations/tradition**: What are the expectations of the individuals involved? Does (do) the current leader(s) expect the next generation to take over, and if so, does the next generation want to?
- **Family dynamics/relationships**: How do the family members get along? If there are multiple family members involved in the business, are they comfortable with business discussions rolling over into family time/events/conversations?

So what can families do to help ensure a successful transition?

- **Is a transaction necessary – Capital or income?** Another important consideration that the leader and successor must account for, and be on the same page in regards to, is a potential purchase. If the leader should require a sale of the business, rather than a transfer of this asset to the next generation, will they require immediate capital upfront, or are they okay accepting an income stream over time?
- This factor alone may make or break the decision to transfer to the next generation.
- If the current leader requires capital now, would the preferred successor have assets available to deliver this? If so, when?

So what can families do to help ensure a successful transition?

- If a trust is utilized as part of succession planning
  - the Trust Agreement should set out the names of the trustees, defines the beneficiaries, outlines what property is being transferred, and establishes the criteria for distinguishing the income from the capital of the trust.
  - A living trust is contained in a separate legal document.
  - In the case of a testamentary trust, the terms of the trust are outlined in the will.
  - One of the key elements of a trust is the powers that the trustees have to manage the trust. This includes managing any future crystallization given the 21-year life of the trust?

valuable tax benefits to conducting an estate freeze.

- These include the minimization of probate fees (since shares will not pass through estate)
- It also enables family members to become shareholders and to contribute to the future growth of the corporation at a minimal cost to them.
- Income-splitting opportunities through taking advantage of other family members' lower marginal income tax rates is another benefit.
- An estate freeze is a beneficial mechanism for enabling family members to participate and share value in a family business (common/growth shares are normally issued for nominal value - family members can acquire and hold equity in the family business for little consideration).
- Estate Freeze (Rollovers) Types – Section 85 (holding company), 51,

  86 reorganization (no holding company)

- **Section 85 Rollovers (use of holding company)**
- A transfer of a sole proprietorship or a partnership to a corporation takes place under section 85. Section 85 is the general rollover provision for capital assets and is used in many different types of reorganization.
- Under section 85, the disposition of property may give rise to the recognition of gain or loss by the taxpayer. The resulting tax liability may however be deferred on a transfer by a taxpayer to a corporation for consideration that includes shares issued by the transferee.
- Some of the most common applications of section 85 are listed below:
  - The incorporation of a business by an individual or a partnership;
  - The creation of a holding company by an individual or a partnership;

- **Section 85 Rollovers**
- The transfer of property to a corporation in the context of an estate freeze and/or income splitting reorganization;
- The transfer of property within a group of corporations for business or tax reasons;
- The division of a corporation under paragraph 55(3)(b);
- The purchase of property for consideration which consists in whole or in part of shares.
- Section 85 of the Act does not restrict the deferral of tax liability to a specific type of transaction nor to a transaction carried out for a specific purpose. It applies to any disposition of eligible property to a taxable Canadian corporation. Common control is not required and the transfer need not be reorganizational.
- However, most elections under section 85 involve related parties or pertain to reorganizations, because the deferral of tax liability on the transfer of property is conditional on shares of the transferee being received as consideration by the transferor.

- A section 85.1 rollover is designed to provide a tax-free rollover to a taxpayer who held shares in an acquired corporation and as a result of the takeover or attempted takeover, the taxpayer exchanged those shares for shares in the corporation that purchased the acquired corporation.
- In order for the rollover to apply, the taxpayer must have held the shares in the acquired corporation as capital property and the consideration received for these shares must be newly issued shares of the purchasing corporation.
- The cost to the purchaser of each of the shares of the acquired corporation is generally the lesser of Fair Market Value (FMV) of the share and its paid-up capital (PUC).

Section 51 Rollover

- An estate planning situation might require a share conversion. Section 51(1) of the Income Tax Act is a rollover approach that permits a taxpayer to exchange a convertible property issued by a corporation for shares of the corporation on the basis of a tax-free rollover.
- Convertible properties are capital property such as a share, bond, debenture or note of the corporation that contains a conversion privilege.
- In the course of an exchange of convertible property, a taxpayer may be entitled to receive a fractional interest in a share.

Section 86 Rollovers (reorganization/no holding company)

- Exchange of Shares by a Shareholder in course of Reorganization of Capital is an approach for estate planning under Section 86 of the Income Tax Act.
- A section 86 share exchange facilitates a tax-free rollover in the situation where, under a reorganization of the capital structure of a company, a taxpayer disposes of all the shares of any particular class of the capital stock of the company in consideration for which property is receivable by the taxpayer from the corporation that includes other shares of the capital stock of the company.
- Generally, in a section 86 reorganization, common shares of a business would be converted into common and preference shares. The preference shares would be fixed-value shares with their value being equal to the fair market value of the business at the time of the reorganization.

Section 86 Rollovers

- As all of the value of the corporation will be reflected in the value attributed to the preference shares, the new common shares will have nominal value.
- These new nominal value common shares can then either be transferred directly to members of the next generation or can be transferred to a trust for members of the next generation (see the discussion below) without any adverse tax consequences.

Estate Freezes – Section 85 Rollover: Example - Frank

- Frank is a dentist who is operating his practice as a sole proprietor. In the early years, this structure met his needs because he spent his entire net income on his lifestyle needs. Now, the practice's net earnings exceed his personal spending.
- Frank will incorporate a new corporation (ProCo), which he'll operate as a professional corporation. He'll transfer his equipment and office furniture to ProCo at an Elected Transfer Price (ETP) equal to the tax cost of the assets, using section 85.
- In exchange for his assets, Frank receives a promissory note from the professional corporation, equal to the tax cost of the assets, along with shares of ProCo.
- Frank and ProCo must file a joint election (CRA form T2057), due by the earliest date either party must file an income tax return. Frank and his advisors will need to determine if any goodwill is attached to the dental practice, as it will also need to be transferred to the corporation at an elected transfer price.

Estate Freezes – Section 85 Rollover: Example - Frank

- The amount that Frank and ProCo choose as the ETP for each asset becomes Frank's proceeds of disposition on the sale of each respective asset. The ETP also becomes ProCo's tax cost of the assets.
  - For example, Frank transfers the dental equipment, office furniture and goodwill to ProCo in exchange for $75,000 of promissory notes and $65,000 of common shares.
  - The accrued gain (fair market value in excess of the tax cost) on each of these assets has been deferred and the gain is now embedded in Frank's common shares of ProCo, which have a fair market value of $65,000 with an Adjusted Cost Base (ACB) of $1 (ETP less promissory notes).
    - Source: http://www.advisor.ca/tax/tax-news/how-to-use-a-section-85-rollover-199077

Estate Freezes – Section 86 Rollover Example - Hugh

- this strategy freezes the amount of corporate capital gain that's taxable in a business owner's estate. After a properly structured freeze, any further growth in the company's value will accrue not to the principal shareholder, but to his or her successors or (more commonly) to a discretionary trust set up as part of the freeze.
- Consider this example. Hugh is a Canadian citizen and resident who's been running an active business for 10 years. He's the only shareholder, with 100 common shares at an estimated current value of $5 million. Hugh expects the value to at least double by the time he retires. To limit the tax payable on his death, Hugh is considering an estate freeze.
- If the estate freeze proceeds, section 86 of the ITA lets Hugh exchange his common shares for preferred shares bearing an aggregate par value equal to the appraised value of the business. This reorganization would be permitted on a tax-deferred basis. Immediately after, new common shares could be issued to Hugh's adult children, or to a discretionary trust for their benefit.

Estate Freezes- Section 86 Rollover Example - Hugh

- Since Hugh would then hold fixed-value preferred shares, any future growth in the value of the company would accrue to the common shares held by the trust. Once the freeze has been implemented, it's possible to know Hugh's maximum capital gains tax on death, allowing for better planning.
- Another variation of the estate freeze could proceed under section 85(1). Here, Hugh would contribute his common shares in the operating company for preferred shares in a new holding company.
- Again, common shares would be issued to Hugh's children, or a trust for their benefit, allowing future growth of the company to accrue outside of Hugh's death tax exposure.

Estate Freezes- Section 86 Rollover Example - Hugh

- For the rest of Hugh's life, the preferred shares can be redeemed to provide funds for retirement. The share redemption will further reduce the value of assets that are taxable in his estate. But it would also erode his voting control of the company, so it's crucial to structure the shares in the frozen company according to Hugh's objectives.
- Setting the value of Hugh's preferred shares is of critical importance for effectively freezing the current value of the company.
- Getting an independent valuation of the corporation from a qualified business appraiser is key to the success of the estate freeze because CRA will scrutinize the stated value of shares.

Before executing an estate freeze…

Develop a succession plan owner should

1. Think about who will take over the business
   - What if one child wants the business and other child/children don't?
   - What if it's not yet clear who wants the business (eg. when children are still young)?
2. Create a plan to develop that child/children on the job so they're prepared to run the business when the time comes
3. Create a back-up plan to ensure support is there for the child in the event of owner's premature death
4. Monitor the plan and revise as needed

Before executing an estate freeze…

- Meet with the company’s management team
- Ensure everyone understands – and ideally supports - your plans
  - These people will be key to child’s success when the child takes over the business

Before executing an estate freeze owner should…

- Meet with family members to ensure everyone is onside
- Especially important when have several children, not all of whom will get shares in the business as a result of the freeze
  - In this case, consider methods to equalize estate for non-participating children

A December 2016 Investment Executive article *"… financial planning…being important to both meet financial needs and also a client's emotional anxiety."*

http://www.investmentexecutive.com/-/from-social-work-to-finance?redirect=%2Fsearch

- The financial planner may not do the counselling directly, but in the same way as a lawyer/accountant is recommended on specific topics, so would a wellness consultant and couples counsellor in order to facilitate a client's decision making.
- It was stated that a growing understanding of behavioral finance is changing the way the investment industry approaches financial planning.
- The following 2 cases illustrate conflicting duties/loyalties impact succession planning decisions.

The following 2 cases illustrates conflicting duties/loyalties impact succession planning decisions. – What do you recommend?

1) Catherine's Advertising Company

2) D&D Travel

(i.e., through an Estate Freeze/Trust)

For qualified farm property

- depreciable property can be transferred to children at any value between its undepreciated capital cost (UCC) and its FMV.
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Thus, no capital gains has to be reported.

http://pallisterfinancial.com/corporate-video/

Source: Tom Hyde, Financial Advisor, Pallister Financial Group, Portage La Prairie, Manitoba

Case – McDonald Farm – Alberta (succession planning questions & options)

- Consider this example. Don McDonald is a Canadian citizen and farmer in Alberta who has been running a large active 400-acre farm for 20 years. Two full-time employees assist Don in running the farm.
- His son, Tom, is a lawyer and has no interest in farming, but his grandson, Alex, does and will graduate from a local agricultural college in 2 years. He has been working on the farm with Don from an early age.
- Don's wife (Janet) would like to travel after living with Don at the farm for 30 years. Don and Janet need revenue from the farm to fund retirement.
- As a financial planner, what are some key questions that need to be answered in developing a succession plan?

Uses of Life Insurance for Succession Planning

- Often life insurance can play a key role in transition planning, especially if there is a liquidity event (i.e., an event that may trigger an immediate need for cash such as funding a potential tax liability upon death).

1) Equalize inheritance for heirs

- One child inherits family business
- Other child gets life insurance $

2) Fund buy sell agreements for business buy-outs

a. Crisscross
b. Corporate owned
c. Trust owned

- Proceeds bypass the will & the estate
→ avoids probate

- Creditors cannot access

Use of life insurance fits all forms of business

1. Proprietorship
2. Partnership
3. Company (corporation)

In brief: Disadvantages of life insurance

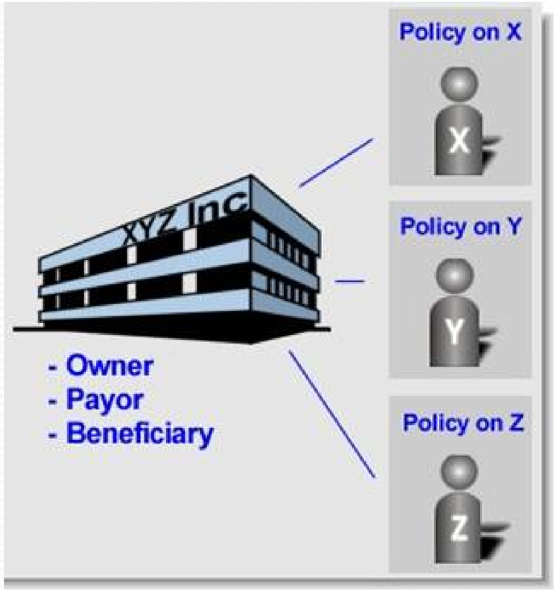
- Premiums increase as you age
- Health considerations
- Ties up cash flow that could otherwise be directed toward potentially more lucrative (in the long run) investment

Buying out heirs with a buy-sell agreement

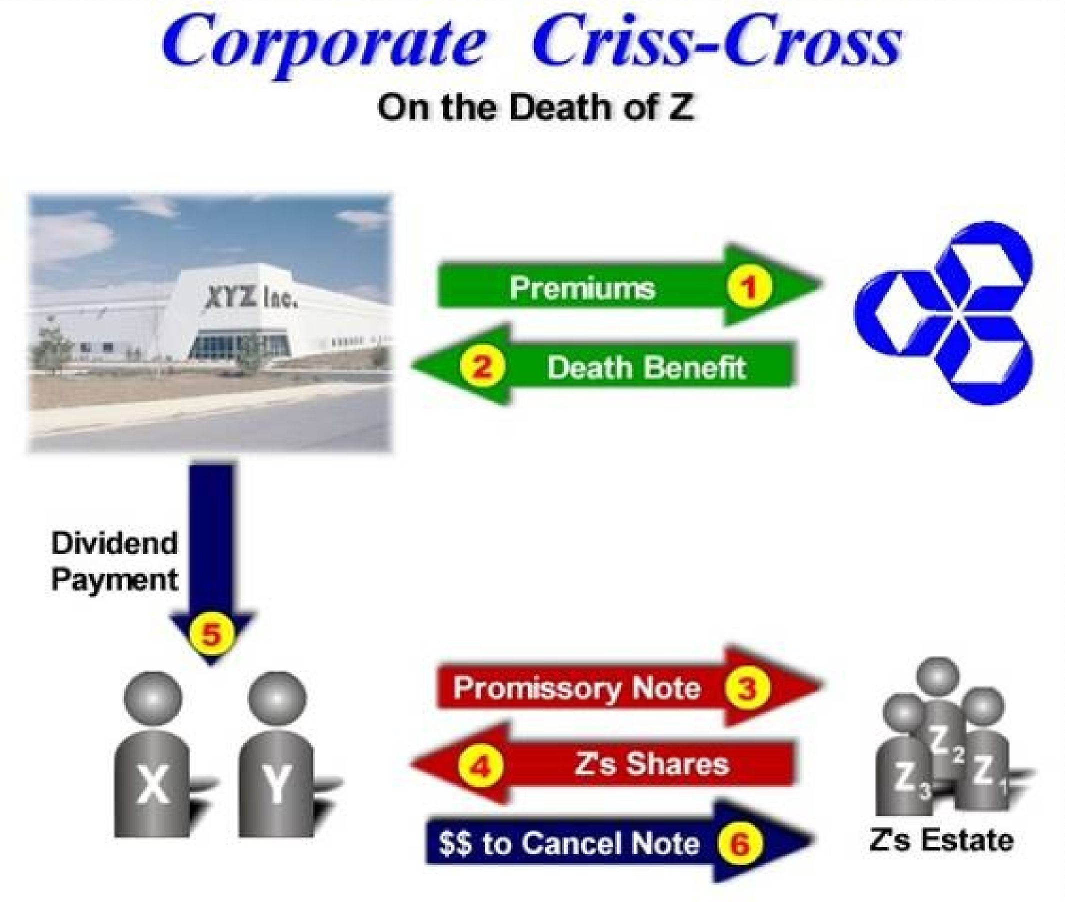
- Eliminates many of the conflicts associated with the other outcomes
- Most effective way to provide an orderly transfer of ownership
- Reflects views of all owners before the event
- Ensures business continuity
- Heirs can be guaranteed fair price and can buy back in if that is what is desired
- Control over what happens in case of worst case scenario

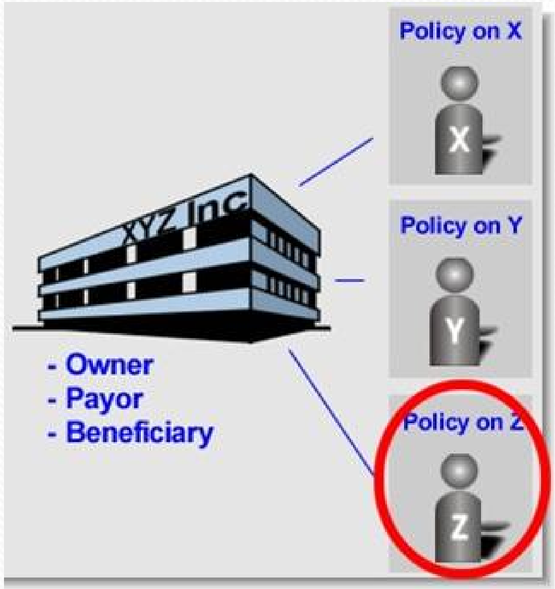
What exactly is a buy sell?

- If “z” dies
  - Shares go to “z” estate
  - Tax free life insurance proceeds are paid to XYZ inc.
  - “x” and “y” issue a promissory note to “z” estate
  - “x” and “y” are paid a dividend to retire promissory note



Flow chart for a buy sell





Pros and cons of a corporate owned buy/sell

PRO

- Corporate cheque book vs. personal cheque book
- More equitable cost sharing because company pays all premium
- ACB of acquired shares rises for surviving owners

CON

- Insurance proceeds may not be creditor proof
- "z" final return has a capital gain – reduced by any Capital Gain Exemption

Funding the agreement

- Reactive funding
  - Burrow to buy out heirs
  - Sell business assets or fund from earnings
- Proactive funding
  - Building a fund over time
  - Purchase life insurance on owners

Closer look at reactive funding agreements

- Burrow to buy out heirs
  - Will the company get that type of loan at that point
  - What interest rates would have to be paid
- Sell business assets or fund from revenue
  - Market timing might not be conducive to liquidating assets
  - Business assets are not easily liquiditable
  - Company may lose a potential source of income

The High Cost of Borrowing

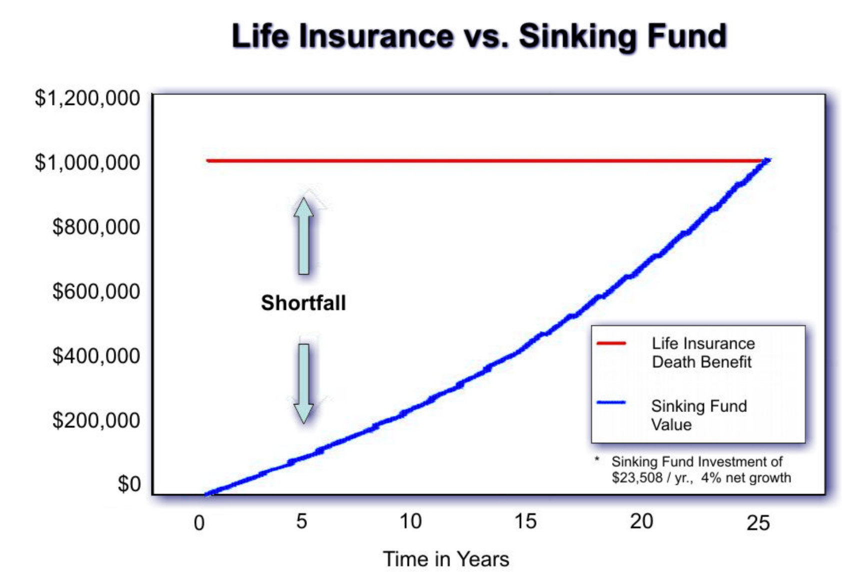
Annual Payments Required for a Loan of $1,000,000

Loan Rate *	Loan Period (In Years) 5	10	15
6%	$237,396	$135,868	$102,963
7%	$243,891	$142,378	$109,795
8%	$250,456	$149,029	$116,830
9%	$257,092	$155,820	$124,059

* Annual Effective Rate

Closer look at proactive funding agreements

- Build a fund over time
  - Requires cash from current flow
  - The fund might not be adequate if death occurs in earlier years
  - Growth in fund may be taxable each year
- Purchase life insurance
  - Requires cash from current cash flow
  - Creates adequate funds immediately, regardless of when death occurs
  - Life insurance is tax effective



Various Types of Life Insurance

- 10 year term
- 25 year term
- Permanent (with or without indexing)

- People must be able to qualify for life insurance coverage based on health and medical history
- The buy-sell agreement has to be reviewed from time to time to ensure it keeps meeting your needs

Steps for use of life insurance

- Define a formula to value business
- Legal advisor/accountant draw up a buy/sell or share holder agreement
- Decide which type of life insurance is the best fit
- Apply for life insurance
  - Have to see if parties can all be insurable

March 2017Budget document…

Stated that the government is currently reviewing tax planning strategies involving private corporations with the following focus…

- Sprinkling income using private corporations, which can reduce income taxes by causing income that would otherwise be realized by an individual facing a high personal income tax rate to instead be realized by family members who are subject to lower personal tax rates (or who may not be taxable at all).
- Holding a passive investment portfolio inside a private corporation, which may be financially advantageous for owners of private corporations compared to otherwise similar investors.
- Converting a private corporation’s regular income into capital gains, which can reduce income taxes by taking advantage of the lower tax rates on capital gains.

The government plans to issue a paper before 2018 outlining the perceived issues in more detail, as well as proposed policy responses. As such, we may see further changes coming to the taxation of private corporations.