

Succession planning? Think about taxes

Get past the denial and depression about retirement and deal with the tax implications of business succession within the family



By **Dino S. Infanti CA**

Business owners dream about how they would like to spend their retirement. In these dreams the decisions to be made are: Is it possible to play golf every day? Should I spend winter in Mexico or Palm Springs? However, as retirement approaches the real decisions become clearer, and many owners find themselves ill-prepared to deal with the succession of their business.

It's common for business owners to go through what we like to call the five stages of retirement. Denial is often the first stage. They may ignore their rapidly approaching retirement date and make no attempt at forming a succession plan or training a replacement. During the second stage, they may become frustrated, and relate differently towards the person taking over their position. In the bargaining stage, retirees may attempt to negotiate with themselves a way to avoid retirement completely. In the fourth phase, depression can set in and succession planning may be further delayed. Finally, business owners reach the acceptance stage.

During this final stage they're ready to begin succession planning. The decisions then become: How am I going to sell my business? Who is going to buy my company? An employee? Family member? Do they have the money? How much tax am I going to pay? Are my children capable of managing the business? Principals must therefore plan well in advance to ensure the succession of their business takes place in a seamless manner. With any succession plan, the financial, non-financial and taxation

matters need to be addressed.

Where the succession is intended to be with family members, the "soft" issues cannot be undermined. When dealing with family dynamics, you need to tread carefully. For example, imagine a scenario where the owner's daughter is active in the business and the son is inactive in the business. The owner may decide to transfer the shares of the company to the daughter but leave the son other personal assets.

Over the years we have all read stories regarding inadequate planning for the transition of the family business from one generation to the next. High-profile feuds have destroyed the families' harmony and tarnished the businesses' reputations.

In determining whether to transfer the business to the children, the owner must consider such factors as the maturity and business acumen of the children, family relationships, and protecting the family's company from any potential marital claims that may arise against the children.

In our experience, it is important to involve all family members in the business succession discussions. This keeps a level playing field whereby the children will feel as though they are being treated equally and their views and opinions are being considered. Without such open group discussions, there is often "back room" dealing that can result in a breakdown of the family relationship.

As long as the owner is alive, the children may get along in the business. However, the owner also needs to consider how the children will interact in the business after he or she has passed away. A carefully crafted shareholders' agreement will address deadlock and exit situations. For example, a shareholders' agreement may contain a clause that requires a child who wants to exit the business to firstly sell the shares to the remaining children. In addition, it may

be of interest to assemble a board of directors that includes outside expertise to provide business guidance to the children while they own the shares.

Some of the income tax advantages of transferring the shares of the company to the children during the owner's lifetime include income-splitting, multiplying the enhanced capital-gains exemption, and fixing the owner's taxes that will be payable at time of death. Some techniques that an owner may consider when transferring the business to the children, and some of the taxation issues related thereto, are:

Techniques of transferring the business

Generally, there are three methods the owner may consider when transferring the business to the children: Make a gift of the shares, sell the shares, or freeze the value of the existing shares and issue future growth shares to the children.

Gift or sale?

When owners intend to give or sell the shares to their children, they must transact at fair market value in order to avoid adverse income-tax consequences.

A gift or sale of shares to the children by the owners can be structured to take advantage of the \$750,000 capital-gains exemption. Every Canadian resident individual is entitled to the enhanced capital-gains exemption where they own shares of a small corporation and certain conditions are met. A gift or sale of shares to children should take advantage of the capital-gains exemption.

In structuring a gift or sale of shares, the parents should consider whether they require some or part of the purchase price of the shares or whether they will continue to draw income from the company in order to finance their retirement. In addition, parents should consider whether they want to relinquish control of the business to the children.

Often the children may not have the financial ability to purchase the parents' shares of the business, and the parents

want to retain control; therefore, planning for a hybrid solution is generally considered. Such planning is referred to as an estate freeze.

Estate freeze

An estate freeze fixes the value of the parents' shares of the company at their current fair market value, and via various tax summersault transactions, the children become shareholders of the company for a nominal amount and thus share in the future growth of the business. If properly structured, the transaction will take place at fair market value, the children will not have the financial burden, the parents retain control of the business, and the children will participate in the future growth of the company.

The ability to freeze the value of the company and to permit the children to subscribe a nominal amount for the future growth is fair, as the children's

participation in the future growth of the company will be based on their efforts, while permitting the parents to retain the right to be paid for their historical contributions to the business.

In our experience, it is important to involve all family members in the business succession discussions.

Such planning can be customized to accommodate family dynamics and provide marital spousal protection through the use of an investment holding company or a family trust. A family trust can be interposed to own the future growth shares, whereby the children are the beneficiaries

and the parents are trustees and retain control. A family trust provides greater flexibility, in particular where one child may be active in the company and another child is not.

Planning for your business succession with the next generation requires a thorough review of your family's personal and financial circumstances, the parents' needs, and the preferences of the active and inactive children in the business. Such planning may be relatively complex and requires obtaining advice from a competent tax accountant; however, it can ensure your objectives are achieved at a minimum cost. †

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