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# Family Business Succession-Planning

**A** study conducted by the Family Business Institute reveals the following.

- 30% of family businesses survive the first generation.
- 12% are still operating into the third generation.
- 3% of family businesses operate into the fourth generation and beyond.

Research reveals the major cause of this failure is the lack of proper family-business succession-planning.

Most of the time, planning is not discussed until there is a life event that forces the family members to devote the time to plan but, by then, some important options may have been missed.

Effective succession-planning requires a careful balancing of business and personal needs. Businessowners should be realistic and should focus on keeping a good communication line with family members on the succession goals during the planning process, to avoid disagreements and possible litigation in the worst-case scenario.

## Goals Owners Aim to Accomplish during the Succession-Planning Process

- Accumulate, preserve, and transfer the wealth of the business
- Minimize and defer taxes

- Avoid family disputes and litigation
- Provide funding for any tax liabilities arising from the transfer of wealth

Succession-planning is a process that involves many areas of a business; it may be complex and it may require the use of expert and professional advice—legal and accounting, tax, and financial planning consultants.

**Effective succession planning requires a careful balancing of business and personal needs.**

## Some areas that Need to be Considered during the Planning Stages from a Tax Point of View

### Available Capital Gain Exemption

The current capital-gain exemption on the sale of shares of companies that qualify for the small-business corporation exemption is \$800,000. The plan should review whether family members have available exemption and if the shares of the business qualify for the exemption. If not, the plan should investigate if the company can be purified to remove excess assets not used in the active business of the corporation.

To multiply the use of the capital gain exemption, consideration should be given to use a family trust structure

where the shares of the business are owned by the family trust and the family members are the beneficiaries of the trust.

### Asset Protection

Consideration should be given to ensure the corporate assets are protected from creditors or litigation. For example, is there a separate holding company to keep some assets (land and building) separate from the operating company?

A review should also be made to ensure whether the transfer of assets to a spouse or other family members is advisable.

### Income-Splitting

Various anti-avoidance rules have been legislated to remove the opportunities to income-split among family members, for example, attribution rules on the income from assets transferred between family members, Kiddie Tax on income earned from minor children, and superficial-loss rules on losses incurred on transfer of assets between family members or associated companies.

For an effective succession plan, businessowners must be aware of the rules.

### Wills and Probate-Planning

Do the family members have a Will that reflects all the personal circumstances?

Does the appointed executor have the right experience to deal with the business and its assets?

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Consideration should be given to strategies to reduce probate fees.

- Are assets held jointly?
- Is a spousal trust or an alter ego trust required?
- What are the advantages or disadvantages of those instruments?

A family trust can be considered. It is a great planning tool but comes with the time limitation of 21 years. After 21 years, a deemed disposition of the assets held by the trust is triggered and the trust can be subject to capital gains tax on the gain accrued since its inception.

### **Estate Freeze**

An estate freeze is a strategy to implement during the succession-planning process. With that strategy, the value of the assets with continued growth is fixed in exchange for similar assets, for example, the shares of a small business are exchanged with preferred shares at the current market value, therefore freezing the value of the business in the hands of the current owner. New-growth common shares are issued to family members (children, for example) and the new future value accrues to them.

### **The Advantages of an Estate Freeze**

- To fix the capital gain tax liability to today's level
- To transfer asset growth to children (successors of the business) and defer the tax on those assets
- To enable the purchase of shares by employees of the company
- To allow income-splitting opportunities among family members
- To enable the retiring businessowner to receive a stream of payments on the preferred shares received from the freeze, by way of dividends or by redemption of the same shares

An estate freeze is usually carried on when the businessowner has decided who among the family

members will be the business successor. The freeze will ensure that any future growth in the business will accrue to the younger generation with deferral of capital gains tax if the business is later sold.

Very often today, the new future growth shares are issued to a discretionary family trust, having the children and other family members of the retiring businessowners designated as beneficiaries of the family trust. That strategy will enable the business to income-split the dividends on the shares to the various family members and to multiply the capital gain exemption in the event of a sale of the business.

It is important to choose the right time to do an estate freeze. If it is done too early, the businessowner may not have enough value to live on in the future.

### **What an Estate Freeze Looks Like**

Let's assume John owns 100 shares of ABC Co. with a total value of \$1,000,000. John wants to retire and wishes his two children John and Mary to take control of the business, but they have no funds to purchase the shares for \$1,000,000.

John will exchange his 100 shares for preferred shares with a value of \$1,000,000, using the tax deferral provision of the *Income Tax Act* under section 85. The shares are redeemable at the redemption value of \$1,000,000.

The company will issue new common shares to the children so the new growth accrues to them.

John now owns \$1,000,000 worth of preferred shares and he is subject to capital gains tax in the event of his death or if the company is sold. John now has the ability to request the preferred shares to be redeemed and reduce the value, subject to the capital

gain. The redemption of the shares will be paid from cash flows generated by the company and the redemption will trigger a taxable dividend to John. To minimize the tax on the dividends, the redemption can be scheduled over a few years.

The new common shares of the company can be issued to a discretionary family trust to enable the trust to pay dividends to different family members and to multiply the utilization of the capital gain exemption when the business is sold and if the shares qualify for the exemption.

To qualify for the exemption, the shares must be of a qualified small-business corporation.

- The company must be a Canadian-controlled private corporation.
- At least 90% percent of its assets must be used in an active business in Canada.
- In the 24 months preceding the disposition of the shares, the shares must not have been owned by anyone other than the individual selling them.

For the issues mentioned earlier, business succession-planning is a dynamic process that cannot be left until the very end when it is too late. Due to the complex nature of the laws and regulations and different strategies involved, it is essential that a proper and regular consultation is conducted between and among family members with the assistance of expert advisors, to enable the parties to meet the needs and goals of the plan. ▲

*Please consult a financial professional to discuss your specific situation.*

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