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What's Your Succession Plan?

Managing the day-to-day operations of your business can be all encompassing. This is especially true once the COVID-19 pandemic gripped the world. While your focus rightfully remains on the short-term viability of your business, the need for an effective business succession plan is likely more important in 2020 than ever before.

How do I create an effective business succession plan?

The biggest obstacle that most business owners face in creating a business plan is their personal attachment to the business. For many owners, they have spent the better part of their adult life investing their time and talents into the business. It can be difficult to even entertain the idea of walking away from this.

A business succession plan should address the following key areas:

1. Legal and tax implications
2. Owner's retirement
3. Desired time line
4. Mechanics of the transfer
5. Division of future profits after the transfer
6. Management succession plan (if passed to a family member)

For the plan to be implemented successfully, family members and senior staff within the business should be consulted to ensure there are no surprises or hard feelings. Treating all family members equally within the succession plan can be difficult, especially if not all members are active within the business. The succession plan should include an emergency plan should the owner pass away or become disabled prior to the plan being implemented. This can be done thru the use of an enduring power of attorney document. Lastly, a time line should be put in place to ensure everyone has a clear understanding of the process.

Implementing a Business Succession Plan

The key to the successful implementation of a succession plan is communication. Once the under lying framework of a plan has been agreed upon, the plan should be shared with senior employees, customers, family members, and other important people in the owners circle of influence.

Some of the major concerns that a business owner will encounter in this stage of the process include: financing, calculation of purchase price, and determining payment terms. Additionally, if the business is being transferred within the family, this creates a unique set of challenges, namely, family dynamics if some of the children are not actively involved.

An estate freeze or a form of vendor take back transaction is typically used in the situation where the business is transfer within the family. The estate freeze provides financing though the exchange of existing shares for preferred shares by the owner. A vendor take works in a similar manner, but a note is held by the owner instead of shares.

The goal of the succession planning should be to preserve wealth for the owner, rather than protecting a name or other cause.

Putting the Company in Saleable Condition

Regardless of whether the business will be transferred to a family member or to a 3rd party, the owner should get the business into a "saleable" state. This includes filing all tax returns to date, clearing liabilities that aren't essential to the business, removing personal assets and amending shareholder agreements to ensure the owner can sell his stake in the business for the highest possible value.

Valuation

Typically a valuation would be conducted by a third party but this may not be practical for smaller businesses. Your accountant however should be able to assist in this area. If the value of a business is directly tied to the business owner's skills or personality, it can be difficult to value and sell.

Discretionary, non-recurring or extraordinary expenses and non-arm's length transactions should be adjusted for. Earnings should also be normalized to ensure amounts paid to family members are removed and market based wages are included to account for management wages.

Typically the valuation process should provide a range of values that can be then used as a starting point for negotiations. Keep in mind that the true fair market value of the business is what you are able to obtain on the free market from an educated investor.

Reorganization

A reorganization is generally completed to minimize any taxes that might arise when carrying out many of the steps for succession. Other benefits include protection from creditors and the transfer of non-active assets in an effort to make the business more attractive to a potential buyer. A reorganization can help shares of the business qualify as QSBC shares in order to take advantage of the LCGE.

A purification transaction may be necessary to remove non-active assets in conjunction with the reorganization and can be done through paying down debt, pre-paying business expenses or paying bonuses or dividends. If non-active assets have significant gains, a divisive reorganization or butterfly transactions will be needed in order to transfer said assets with minimal tax consequences. Once the company has been purified, the owner can then decide to crystallize his/her LCGE by disposing of shares in order to generate a capital gain which is then sheltered by the exemption. This can be accomplished by transferring shares to a third party, family member, trust or holding company.

If the fair market value of the shares is greater than the available LCGE, the owner can elect to exchange the shares at a value equal to the available exemption. If the LCGE is not available, the owner may still achieve a reduction of the capital gain on the disposition of shares by first removing "safe income".

Transfers to Family

There are a number of different options available to the business owner should he/she decide to transfer the shares of the business to a family member.

Gift of shares: This would result in a disposition at FMV and possible capital gains tax. Depending on the structure of the company, the gift may qualify for the LCGE. CRA may challenge the determined FMV when shares are gifted to children. This is not a valid option if the business owner needs capital for retirement.

Sale of shares: Although the owner may not require capital, he/she may require it in order to generate income throughout retirement. Any sale to a family member will be deemed to be at FMV, regardless of the amount received. Unfortunately, children who purchase shares for less than FMV will have an ACB equal to the amount paid even though the owner reported the disposal at FMV. A payment plan could be used to defer payments over a number of years. This would allow time for the children to grow the business and would reduce the tax impact on the business owner, upon disposal, as a reserve could be claimed.

Estate freeze: An estate freeze is a tax efficient way of transferring shares to the owner's family and is useful when the owner doesn't need cash immediately. The freeze limits the tax liability that arises on death by fixing the owner's shares at their value when the freeze is implemented. Tax on the future growth of the company would be taxed in the hands of the children. The transfer can be completed on a tax-deferred basis through the exchange of the owner's common shares for preferred shares.

Retaining control: The owner can retain control of the company through voting preferred shares or a separate class of super voting shares. A shareholder agreement can also be used to protect the owner's interests and rights.

Ensuring liquidity: Beyond redemption of preferred shares, the owner may receive funds from the company via discretionary dividends in order to maintain cash flow. If the business owner needs cash immediately upon retirement, the estate freeze may not be beneficial if the business does not have the cash flow to generate sufficient cash flow. Life insurance can be used to cover taxes in the estate and reduce the need for the company to liquidate assets in order to fund the redemption of preferred shares on death.

Family trusts: An estate freeze can produce difficulties in that shares can end up in the hands of children who have no interest in the company. This can lead to family conflict. In order to avoid this, a discretionary family trust can be set up to hold the common shares. The owner should not be listed as the sole trustee as this can lead to attribution issues. Depending on the circumstances, a QST can be used to transfer the shares on a tax-deferred basis for benefit of the owner's spouse. Trustees need to be aware of the 21 year to ensure adverse tax consequences do not occur. The family trust can be used to ensure that the eventual intended beneficiaries end up with the common shares of the company. The trust can also be used for income-splitting purposes. Care should be taken to avoid TOSI rules.

Instead of transferring the shares to the successor during the owner's lifetime, the shares can be transferred via a Will, alter ego or joint spousal trust. The use of a lawyer in the Will creation process is essential to ensure that the owner's wishes are carried out in the Will. This is especially important where one or more children are not active in the business and the mechanics of equalization need to be determined. Personal questions, although uncomfortable, have to be asked by the lawyer to ensure the family structure is fully understood.

In order to reduce exposure to probate fees, the use of multiple Wills has evolved. One Will contains assets that require probate in order to transfer ownership (real property), the other, contains assets which do not require probate (investment securities, share of a private corporation). Alternatively, the company shares can be placed in joint ownership with the child who is the intended successor but this can open the shares up to claims from the child's creditors. A joint partner or alter ego trust can be used to avoid probate fees if the owner is at least 65 years of age. These trusts are "inter vivos" trusts and draw higher tax rates than a testamentary graduated rate estate trusts.

When selecting an executor, it is important to consider their business acumen and the anticipated time period that the trust will be in existence. Selecting the wrong executor can result in conflicts of interest, family tensions or open the estate up to fees for administering the trust. Life insurance can be used not only to pay for tax liabilities, but to provide for flexibility in equalizing the estate.

Transfer to Employees

Transferring shares to employees instead of family members can provide some advantages; higher sale price, employees are willing to work hard to maintain jobs, confidence in senior employees to pay sale proceeds, reduced disruptions to day-to-day operations and less risk to existing relationships with customers and suppliers.

Typical forms of financing may not be available to an employee so it may be necessary for the owner to agree to a "take back" agreement. Payments would then be made over the course of a number of years to the owner. Security over assets or shares would be given to the owner until all payments were made.

Alternatively, employees can "buy in" into the company thru an employee share purchase plan. The will slowly dilute the owner's interest in the company but will not provide the owner with proceeds for his own shares. An estate freeze could be used to allow for employees to subscribe for common shares at a lower initial investment. Preferred shares of the owner would then be redeemed in the short-term but opens the owner up to risk as the company may not remain profitable enough to cover the share redemptions.

Transfers to Other Shareholders

If the company has a shareholder agreement in place, the owner may be constrained by its terms. The procedure for transferring the owner's shares, the price to be paid and the timing of the share transfer may be laid out in the agreement. If possible, the agreement should be addressed to allow for the owner to pursue options for the sale of his shares that aren't as restrictive.

Transfer to Outside Parties

Selling to outside parties can often involve a different and more complicated process. An owner may need to spend a considerable amount of time looking for a suitable buyer. Discussions with third parties can open the business up to potential disclosure issues should the sale not go thru. Early on, discussions should establish whether the sale will include assets or shares of the company as this will produce differing tax consequences.

Family Trust Agreements

A family trust can be used to acquire all the owner's common shares directly. This strategy transfers the tax burden of future growth on to the children and allows for potential access to multiple LCGE when the shares are eventually sold. Additionally, the trust allows the owner to retain control, protect from creditors and provide for management oversight should the owner become disabled. Care should be taken when setting up the trust in order to avoid attribution rules which reverts income and gains realized by the trust to the owner.

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Family trusts are a complex vehicle for holding the owner's common shares. When considering whether a trust is right for you, the following questions should be addressed in advance:

1. Is the owner old enough and wealthy enough to warrant trust planning? If the owner is still young or he/she will be driving force behind future company growth, it may be too early to execute a share freeze and set up a family trust. The administrative costs associated with maintaining a trust can be high. There needs to be sufficient assets and/or value in the company to warrant this type of advanced planning. Additionally, retirement planning should be done to ensure that the owner will have sufficient funds to maintain his/her desired standard of living. Dividends may be received on preferred shares but this can be unstable if the company does not remain viable throughout the owner's retirement.

2. Is there a possibility that the business will be sold to an arm's length party during the owner's lifetime? An estate freeze and use of a trust works best if the new growth shares can be held by the next generation for a long enough period of time to accrue in value. If the plan is to sell to a third party not long after settling a trust, the benefit of access to multiple LCGEs likely won't be realized. There may be potential future income-splitting options if the proceeds from the sale are retained in the trust. Consider the number of shareholders brought in thru an estate freeze as this can lead to difficulties in a potential future sale. A unanimous shareholder agreement can provide some protection in this scenario.

Conclusion

Building a successful business is difficult. Transferring that business to the next generation or to a third party via sale is even more difficult.

While you may not be looking to retire or sell right now, your business succession plan should already be in place. A successful plan takes into account your family's dynamics, your retirement goals and numerous other important factors.

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