

# **KEEPING IN TOUCH**

## **WITH BUSINESS OWNERS**

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### **HIGHLIGHTS**

In this issue we discuss the following business succession issues:

- succession plan objectives
- tax considerations
- management continuity
- control pending succession
- funding the transition

### **SUCCESSION ISSUES FOR SMALL BUSINESS**

Family-owned private businesses make up a very substantial portion of the Canadian economy yet in many cases little planning is done to prepare for the retirement of the current owners and the passing of the business on to the next generation. This may result from a lack of time on the part of proprietors busy running an active business, from a lack of awareness of the detrimental consequences that can result from a failure to plan for succession and/or from a reluctance to deal with issues which can be contentious among family members or business colleagues. You will find below some of the many issues involved in the business succession planning process.

#### **Succession Plan Objectives**

Although the objective of each business succession plan will vary with the circumstances, a number of considerations will be common to most plans. The following is a summary of some principal objectives (in no particular order) which succession plans are often designed to achieve:

1. To preserve the value and enhance the growth potential of a business and its assets;
2. To foster unity of purpose and prevent disagreements among family members from adversely impacting upon the business;
3. To provide for a non-disruptive transition of control of the business to the next generation;
4. To keep the business in the family or, if that is not possible, obtain maximum value on a sale as a going concern;
5. To provide financial security including inflation protection for the current owners after retirement and ensure the availability of sufficient liquidity to maintain appropriate living standards throughout retirement;
6. To minimize taxation resulting from the transition and defer taxes for as long as possible.

#### **IN BRIEF**

*Proper business succession planning well in advance of implementation increases the potential tax savings and allows for greater flexibility in tailoring the best plan to suit the desired results. Business proprietors are strongly recommended to consider their ultimate goals and to consult with professional advisors to develop an appropriate plan through which these goals can be achieved.*

If an appropriate business succession plan is to be developed and successfully implemented, the owners of the business must develop a comprehensive list of objectives in light of their own expectations and circumstances and assess the relative importance of each of those objectives. It may not be possible to accomplish all objectives in an entirely satisfactory manner but only through careful planning, frank discussion and creative thinking involving all individuals affected will it be possible for the most advantageous plan to be developed.

## Tax Considerations

The minimization and deferral of taxation should be given a high priority in formulating a business succession plan. Although current taxing statutes are extremely complex with the result that tax planning can also be complex and highly technical, this should not discourage planning. A failure to plan for succession or the implementation of an inappropriate plan can have extremely disadvantageous tax consequences.

For example, the capital gains tax incurred on the transfer of a successful business can be substantial and the diversion of resources necessary to pay the tax can deprive the business of needed working or investment capital or, in the extreme, necessitate its sale or liquidation. A number of strategies are available in appropriate circumstances to minimize taxes payable on the death or retirement of the owner and maximize the deferral of unavoidable taxes, including:

1. Implementation of an estate freeze so that future growth in the business will accrue to subsequent generations thereby minimizing capital gains tax to be incurred on death;
2. Utilizing the spousal rollover of capital assets which permits assets with accrued capital gains to be transferred to a spouse on a tax-deferred basis;
3. Maximizing utilization of all available capital gains exemptions.
4. Ensuring compliance with the technical rules for utilization by each shareholder of the \$500,000 capital gains exemption applicable to qualified small business corporation shares;
5. Minimizing the risk of double taxation by avoiding corporate ownership where appropriate of appreciating assets such as real property.

The structure of a business succession plan will depend upon the circumstances of the business and the objectives to be achieved. A succession plan might involve the immediate gifting of business assets to the owner's successors or the sale of the assets for consideration secured by a mortgage of the assets.

Alternatively, the business assets may be transferred on a rollover basis to a corporation in exchange for fixed value preference shares where the successors hold the common growth shares or, if the business is already incorporated, the existing shares may be transferred to a holding company on a similar rollover basis.

A trust can be employed to hold assets or shares where a decision as to ultimate allocation of ownership among potential successors cannot yet be made. Where a family corporation carries on several businesses which can be divided among multiple successors, a butterfly reorganization may be appropriate. A measure of reversibility can often be included to increase the flexibility available in responding to future changes in circumstances.

## Management Continuity

Closely held private businesses often encounter difficulties when the founding entrepreneur fails to involve the heirs to a sufficient degree at an early enough stage to enable them to gain the knowledge and experience necessary to effect a smooth transition. Unnecessary disruption can also be caused when the potential heirs are either uninterested in or incapable of taking on responsibility for the business.

A dedicated entrepreneurial proprietor in most cases is vital to the success of a small business, the assets of which can often have little independent value when compared to the value of the business as a going concern. Proprietors who are reluctant to contemplate retirement often fail to recognize that the value of the business is highly dependent on their involvement, that their absence can result in a rapid loss of value, and that the full value of the business can only be realized if they are available to assist with the transition.

These considerations further highlight the importance of proper succession planning to ensure that the transition of ownership and operation to the next generation can occur with the minimum of disruption or, alternatively, that maximum value can be derived on the sale of the business. Potential heirs should be brought into the business as early as possible so there is an opportunity to learn at an early date whether they have the interest or ability to take over the business and, if so, to provide them with as much opportunity as possible to learn the business before the transfer of management and control becomes necessary. If there are no heirs able to take over the business, this should be recognized as early as possible so that alternate arrangements can be made in a timely fashion.

Careful consideration should be given to the hiring of professional management to work under the proprietor. This can facilitate succession should the potential heirs prove uninterested or incapable, or an

unexpected tragedy disables the proprietor. Professional managers can ensure the viability of a business until the next generation is able to assume responsibility and, as key employees with vital operating knowledge, they can enhance the value of the business to potential buyers and are themselves often potential buyers.

Where there are several successors in the next generation who will acquire interests in the business, only some of whom may be actively involved, it will be vital to put in place an appropriate shareholders' or partnership agreement setting out the separate rights and obligations of the active and passive participants as well as binding dispute resolution mechanisms to minimize the disruption which protracted disagreements can cause. In addition to provisions designed to achieve consensus, buy-sell rights, which can be invoked in case of irreconcilable disagreements, or rights of first refusal triggered by the death or incapacity of a co-owner should also be included.

Such agreements should be reviewed periodically and updated when necessary to reflect evolving business conditions and family circumstances. Updating is particularly important where the business or family undergoes fundamental change. It will be too late to tailor dispute resolution mechanisms to altered circumstances once disputes have arisen. Agreements should also contain provisions to protect against the adverse impact on a business of claims under the *Family Law Act* (Ontario) which arise out of family breakdown. The involvement of in-laws in succession plans can increase the impact of marriage breakdown where the appropriate agreements are not in place.

### Control Pending Succession

Often of concern to the founding proprietor is retention of control after an estate freeze or other business succession plan is implemented even though ownership interests are transferred to the succeeding generation. Mechanisms are usually available to allow control to be retained until a transfer of control either is considered appropriate or ultimately becomes necessary.

Following an estate freeze, the future generation will typically hold the common shares of either an operating or a holding company and the original owner will retain fixed value preference shares. The number of shares issued and the votes attaching to those shares can in most cases ensure that the original owner remains in full control and conversion rights attaching to the preference shares can add to the means of exerting control. The provisions of a shareholders' agreement can impose qualified majority voting requirements on both shareholders and directors, allocate rights to nominate directors among the shareholders, and define the management rights accorded to various participants

in the corporation.

Substantial control can also be retained where the succession plan involves the transfer of the shares of the business corporation or other property to a trust for the benefit of the next generation. It is often permissible for the settlor to assume the role of trustee under the trust indenture. Additionally, a great deal of discretion can be reserved to the trustee in both the management of trust assets and the allocation of the assets among beneficiaries.

Although each situation is different, careful planning can usually result in the establishment of a structure which effectively achieves the succession and tax planning objectives while allowing sufficient ongoing control to be retained to ensure that the operation and development of the business is not disrupted and that an orderly and appropriately timed transition of control can be achieved.

### Funding the Transition

Although an effective estate plan can substantially reduce the tax burden of business succession, it is seldom possible to fully eliminate all taxes. An estate freeze will usually be most effective in reducing taxes on death and the burden of paying unavoidable taxes will be minimized if the plan is implemented early, before the business becomes highly successful.

To fund unavoidable taxes, a savings and investment program can be established to create a fund for the payment of taxes when they are ultimately incurred. Alternatively, independent divisions capable of being conducted as separate businesses can often be sold advantageously to finance the succession of the core business.

Life insurance is also a common means of ensuring succession funding is available. Although term life insurance can be inexpensive when placed at an early age, the premiums can escalate markedly in later years. Whole life policies, while more costly at the beginning, have the advantage of fixed premiums. A policy of life insurance on the joint lives of spouses and payable on the death of the last to die can be substantially less expensive than comparable policies on their separate lives. Where the spousal rollover of capital properties is available, such a policy may be the most appropriate. Life insurance also has an important role to play in providing funding for obligatory buyout provisions in partnership and shareholders' agreements that are invoked on the death of a co-owner.

### Conclusion

If you are the owner of a business enterprise and have not put into place arrangements designed to ensure the orderly succession of your business, you

should take the time to contemplate what your ultimate goals are for your business and your family and consider how the issues discussed above will affect your ability to achieve those goals.

Although such considerations may seem premature in relation to a succession which should take place many years, even decades, into the future, it is important to remember that unexpected accidents and illnesses can collapse the anticipated time frame. Additionally, the earlier plans are developed and implemented to deal with succession, the greater can be both the potential tax savings and the flexibility in tailoring the plan to best achieve the desired results.

Despite the fact that future events are necessarily uncertain, a well designed and implemented plan can greatly enhance the prospect

that goals will be successfully achieved despite unpredictable adversity. We therefore strongly recommend that all business proprietors make an effort to define their goals and consult their professional advisors to help design and implement an appropriate succession plan.

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