Succession of the Family Business

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The succession of the family business is a very broad topic which encompasses many areas.

These include:

1. Management and control issues concerning the business
2. Valuation
3. Estate planning and financial issues
4. Legal issues
5. Tax issues

There is no set formula for how to transition the business successfully to family members, and it very much depends on the circumstances. There are though certain methodologies which have generally stood the test of time, and which are preferred over other approaches. While the materials focus primarily on tax issue, the other issues will be highlighted in the pages which follow.

Succession of the Family Business

Issue 1

Why pass family business to children?

- Logical and natural successors
- Want to provide a job / career / opportunity
- Want to assist financially
- Provide a lasting legacy
- New talent, skills, and energy
- Easy way to get paid

There are many reason why parents might wish to transition the family business to children.

These may include:

1. The children are logical and natural successors to the parents, particularly if one or more of them have been actively engaged in the business.
2. The family business may provide a job, a career, and/or a financial opportunity to the children.
3. There may be a desire to assist the children financially and, in addition, provide a reward for their efforts.
4. Some families regard the business as a lasting legacy, and want it to remain in the family.
5. The children may have new talents, skills and energy to bring to the business, which will enhance the business and allow it to move to a new level. For example, the children may be more "tech savvy" than the parents and may be able to transition the business to have a meaningful online business.
6. In some cases, transitioning the business to the children may be an easy way for the parents to get paid over time for the business, and maybe preferred to going through an arm's length sale. It may be easier to set up a financial arrangement with children than with outside people.

In practice, there will often be a combination of these reasons, and possibly others as well.

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But

Are children capable?

Are children interested?

What if one is interested, others not?

How to treat fairly?

Will children get along?

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Depending on the family situation, the children may be a part of the problem or a part of the solution in succession. A number of questions should be asked in a constructive and realistic way.

For example:

1. Are the children capable of running the business
2. Are the children interested in the business or would they prefer to pursue a different career or occupation
3. What should one do if say one child is interested and the others are not
4. Most parents would like to treat all of their children fairly, but this does not necessarily mean equally, and will depend on the circumstances.
5. If more than one child is going to be involved in the business, will the children get along with each other

There are no easy answers to most of these questions, and it will very much depend on the circumstances. The more difficult the business is to manage, the more challenging these questions may be.

For example, It may be a lot easier to manage a real estate portfolio than to manage a manufacturing business. It is also necessary to be realistic about the prospects for the business. Many businesses may operate at roughly a break even position, providing a basic salary for the owners, and perhaps the business should be sold or wound up.

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But – cont.'d.

Will there be politics / drama?

What is level of commitment?

Do parents want to be paid?

Can business afford to support multiple families?

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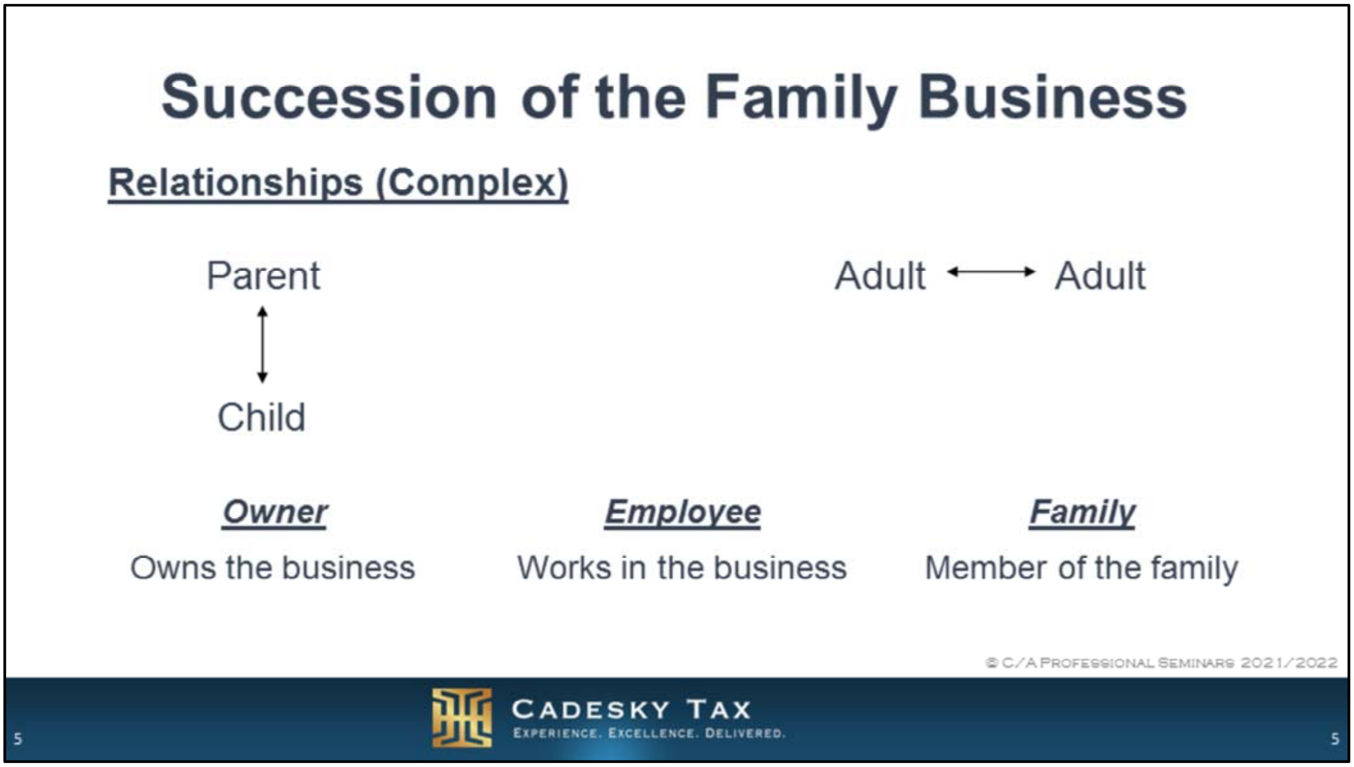
What will be the level of politics and drama in the family on transitioning the business? Will there be allegations of favouritism and, if so, is it justified?

What will be the level of commitment to the business by the children?

Importantly, do the parents want to be paid for the business or will they in effect give it away? Many parents will want to rely on the business for funding of lifestyle in their later years. Partly this will depend on the other financial resources of the parents.

Lastly, can the business afford to support multiple families? The business may have provided a good living for father and mother, but can it provide the same level of financial support for several children each with their own families and their own financial needs.



One social theory is that we operate at three levels in our family relationships.

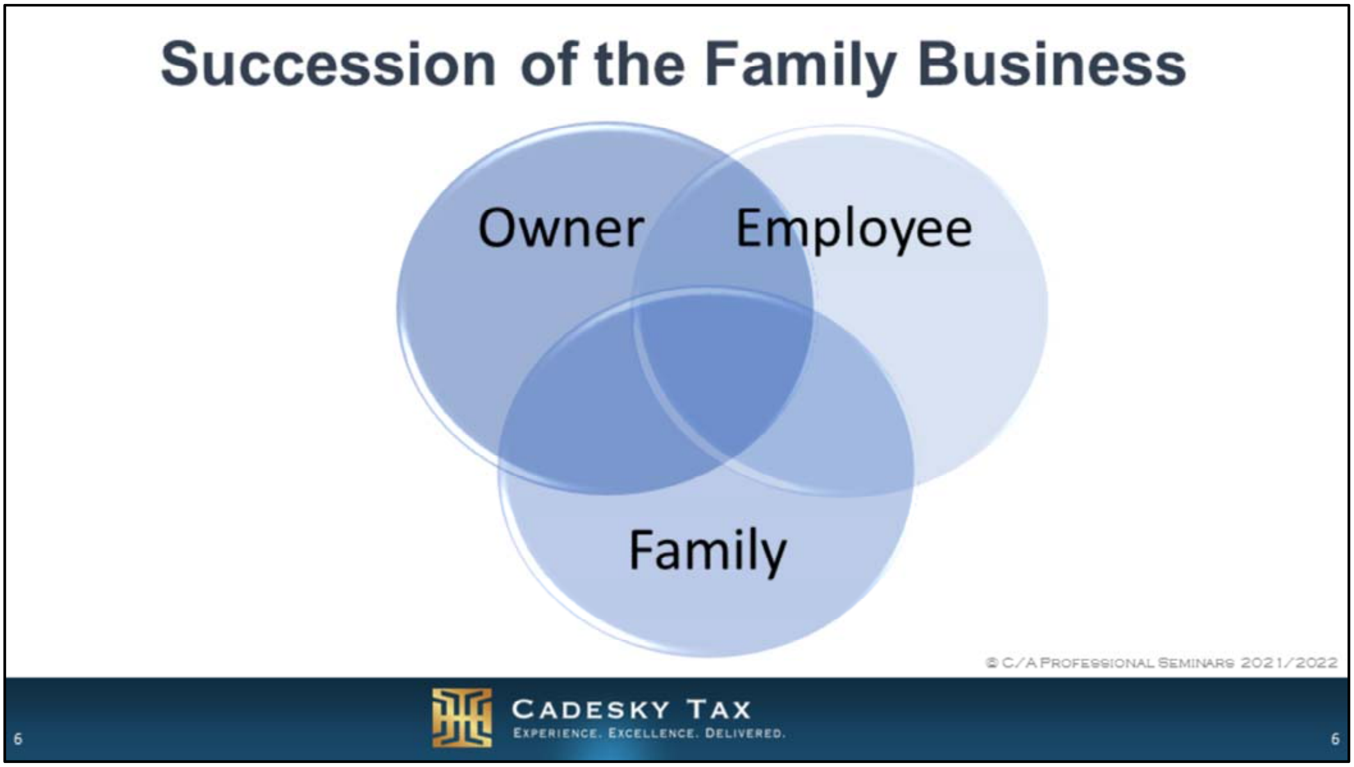
They are:

- Parent
- Adult
- Child

With young children, parents operate in the Parent/Child mode. We educate and discipline our children, and treat them as children. There is a tendency to continue this relationship later in life, even when the children become adults.

With our friends and our colleagues, we operate at an adult to adult relationship. Transitioning this parent/child relationship to the adult/adult relationship with our children can be challenging, both for the parents and for the children. Many parents will have experienced the child saying “I’m not a child anymore, don’t treat me like one”. This can be easier said than done. Sometimes the rebuttal is “If you want to be treated like an adult, stop acting like a child”.

Clearly if a child is to be successful operating in the family business, together with the parents, it needs to be in an adult type relationship.



In a family business, there is the added complexity that people in the family have several different roles such as owner, employee and family member.

The owner is an owner in the business, in simple terms a shareholder, and accrues value from the ownership.

An employee works in the business, and is answerable to the owner of the business.

The individual is a member of the family, regardless of whether he or she is an owner or an employee. The family members all have a place at the dinner table but not necessarily in the boardroom.

There can be a great deal of confusion and controversy with respect to these roles. Some members of the family may have only the family member role, while others may be employees or owners.

To understand this, consider the situation where one child is an employee in the business, but all three children are owners of the business. That child, as an employee, is working for the other two owners, who are not actively involved, and then the question arises as to what is fair compensation. The parents, as owners, may not be actively involved in the business in the future, but may wish to have a say in the control of the business. The children, as employees, now work for absentee owners.

These complex relationships can be difficult to manage, and sometimes become overtly unmanageable. It is important that these relationships be carefully considered.

Finally, not all families are the same, but many will prove to be difficult!

Succession of the Family Business

Peter, Paul and Mary (A Case Study)

Peter (father, widower) founded Company.

Paul (son) is a teacher.

Mary (daughter) active in Company, but not owner.

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For the balance of these slides, we consider a simple set of relationships involving Peter, Paul and Mary. Peter is the father, and we assume for simplicity that he is a widower. He founded a company many years ago.

Paul, the son, is a teacher, and has no interest in the business. Nevertheless, he has an expectation that he will benefit from the business by virtue of being a family member, possibly by inheritance or perhaps sooner.

Mary, the daughter, has been actively involved in the business for some time, and has made considerable contributions, but is not currently an owner.

It is easy to see the relationships of owner (Peter), employee (Peter and Mary) and family member (Peter, Paul and Mary). Luckily Peter only had two children!

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Owner	*Employee*	*Family*
Peter Paul and Mary have expectation of inheritance	Mary is an employee, works to benefit Paul	All are family members at dinner table

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Control

What level of control does Peter want?

How will he deal with issues and conflict?

What is fair to Paul, not active?

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In transitioning the business Peter has a number of questions which he will need to address. For example, what level of control does he want going forwards? How will issues of conflict be dealt with in a way that is fair and reasonable? For example, how much should Mary be paid for her efforts and to what extent should she be given the business or should she be required to pay for it? Lastly, what is fair to Paul in the circumstances.

Succession of the Family Business

Tax Issues

Very much depends on value, nature of business and assets, and liquidity.

What is different to arm's length sale?
Answer- in an arm's length sale some third party is paying

The tax issues will depend on many things including the value of the business, the nature of the business and the assets, and the liquidity available in the business. It will also depend on Peter's other financial resources.

At this point it is worth considering what is different between succession of the family business and a sale to a non-arm's length person.

The simple answer is that on a sale to an arm's length person, there will be cash proceeds commensurate with an arm's length transaction. Although for tax purposes in theory the same gain should arise on transitioning the family business to Mary, there are many ways in which the business could be transitioned in a financially favourable way, which would not be the case if it was sold to an arm's length person. Also Peter would not care particularly about how the purchaser will pay for the business. He cares a lot more when a family member has to pay and may want to assist in some way.

Succession of the Family Business

Family Business (F1 Co):

- allows owners to make a basic wage or equivalent
- breakeven position if owners paid a normal salary
- basically provides owners with a job

Family businesses differ greatly in terms of their size, value, profitability, liquidity, and the nature of the business. There is no “one size fits all” but it is possible to develop certain benchmarks which these slides attempt to illustrate.

In the first case, business F1 Co is a small family business which operates at slightly above a break-even position. It allows the owners to make a basic wage or equivalent through dividend payments. If the owner’s were paid a basic wage, equivalent to what an arm’s length person would be paid, the business would operate at roughly a break-even position. In essence, the business provided the owners with a job.

Succession of the Family Business

Family Business (F1 Co) – cont.'d.

Revenue	$ 2,000,000
Cost	$ 1,800,000
Profit	$ 200,000

Salary if family members replaced with employees - $160,000.

Provides them a job.

Value minimal, say $200,000, plus net assets on hand.

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This shows what the financial position of the business might be, operating at a profit of $200,000 per year annually, but only because the owners, who are family members, do not take a salary. Such a business has a relatively minimal value, after, "normalizing" the income for what would be reasonable salaries. Many family businesses operate like this. Common examples would include a restaurant, retail store, a contracting business etc.

This business may struggle to provide a living to multiple families and may not be of interest to the children.

Succession of the Family Business

Family Business (F2 Co):

Revenue	$ 8,000,000
Cost	($ 6,000,000)
Profit	$ 2,000,000

FMV of business, say 4 times earnings.

Value: $8,000,000

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F2 Co. is a larger business, producing significant profits. Suppose it produces $2,000,000 of profit per year before tax. Also, suppose that such a business would be valued at roughly four times earnings. This produces a value for the company of around $8,000,000. This is significant.

Succession of the Family Business

Family Business (F3 Co):

Same as F2 Co but owns real estate used in the business worth $10 million, bought many years ago.

Value: $18 million (True?)

Business at F3 Co is similar to F2Co except that it also owns the real estate which is used in the business, which was purchased many years ago. The real estate, purchased with the after tax earnings of the business, has appreciated greatly in value, and is now worth say $10,000,000. this means that the value of the business is now $18,000,000, rather than $8,000,000, although the valuation needs to be considered more carefully for reasons which will become apparent.

This business is more complex because of the two aspects; operations and real estate. It would be quite typical.

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Question

Is business more like F1 Co, F2 Co, F3 Co?

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If a CPA is advising on the transition of a family business, is the client's business more similar to F1 Co, F2 Co or F3 Co?

Although, these three types of businesses would be fairly typical, it is noted that this is obviously a great over simplification. There will be businesses that are much larger, and more valuable, but these serve as reasonable benchmarks for illustration.

The case study develops from F3 Co.

Succession of the Family Business

Tax Issues

1. Capital gain if shares sold or gifted to children.
2. Possible use of capital gains exemption.
3. Determine FMV by valuation.
4. What parts of business and assets are transferred (all or some).
5. How to postpone tax.
6. How to fund payment.

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From a tax perspective, a number of tax issues arise.

These include:

1. If the business is sold or gifted to children, a capital gain will arise. Taking steps to minimize the capital gain and/or postpone the timing of when the gain is realized are important considerations.
2. Is the capital gains exemption available and what are the implications of claiming it
3. What is the fair market value of the business, as determined by a valuation. Transactions between the parents and the children will be deemed to occur at fair market value, regardless of the value which is actually assigned.
4. Should the corporation be split, such that the business, for example will transition to one children (say who is actively engaged in the business) while the other assets will transition equally to family members. Several alternatives may be available to restructure the assets of the business, and also postpose taxation on the transition.
5. How can the capital gains tax be minimized and postponed
6. If the parents want to be paid for the business, how is the payment going to be structured

Succession of the Family Business

F3 Co:

Peter owns 100% of F3 Co.

Wants to transition to Mary while being fair to Paul.

Mary helped grow the business.

Peter needs funds from F3 Co for living costs.

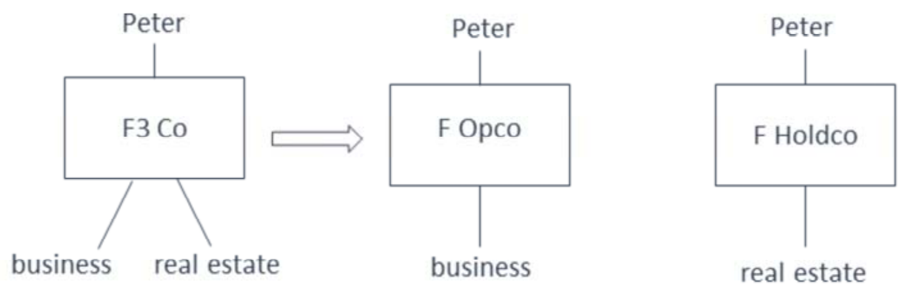
The fact situation of F3 Co, it illustrates a wide range of points.

Assume that Peter owns 100% of F3 Co and wants to transition the business to Mary while being fair to Paul. Mary has helped to grow the business in the past, and Peter believes that she should be rewarded for her efforts.

Peter will require funds from F3 Co for his living costs over time, and cannot afford to simply give away the business. Over time Peter will become less and less involved in the business, and therefore he will be paid in his capacity of owner, rather than as an ongoing employee.

Succession of the Family Business

Butterfly Real Estate



Butterfly reorganization tax-free. Type A butterfly (simpler)

No new entity for business so easy to carry out.

Peter can carry out a butterfly reorganization to split the real estate from the operating business producing F Opco and F Holdco. This transaction is easy to do because it is a type A butterfly rather than a type B butterfly.

In practice F3 Co remains with the business (renamed here to F Opco, but it is the same legal entity). The real estate is moved into F Holdco through the butterfly reorganization.

There will be an exemption from land transfer tax on moving out the building, because, in practice, this reorganization should also qualify as a type B butterfly for which there is an exemption from land transfer tax. Failing this, F Opco and F Holdco are affiliates (controlled by the same person), so this also provides exemption from land transfer tax. Note though that under the affiliate exemption it is necessary to pay the land transfer tax altogether with three years of interest or to furnish a letter of credit for same, and if the two corporation are still affiliated at the end of three years, then the land transfer tax is refunded or the letter of credit is no longer required, depending on the circumstances.

Succession of the Family Business

Butterfly Real Estate – cont.'d.

Fair value rent now charged (say $400,000/year), reduces income of business from $2,000,000 to $1,600,000. Value now $6,400,000. (4 times earnings).

Valuation paradox. Probably F3 Co worth $16.4 million to start with.

When the real estate was owned in F3 Co, which also carried on the active business, it was not necessary to charge rent. Now that the real estate has been put into a separate corporation, rent can and likely should be paid, although it may not be strictly necessary to do so. At a minimum, F Opco should pay rent equivalent to the expenses incurred by F Holdco in owning the real estate (property tax, insurance etc.) failing which these expenses will not be deductible because F Holdco will not meet the test of incurring the expenses for the production of income.

For simplicity, it is assumed that a fair market value rent will be charged, and that will be $400,000 per year of net rent. This reduces the ongoing income of the business from $2,000,000 to $1,600,000 per year, which impacts the fair market value of F Opco.

It is probably fair to say that F3 Co was never worth $18,000,000 to begin with, and some reduction should have been taken for the fact that rent at fair market value was not paid. This can be debated.

Succession of the Family Business

<u>Butterfly Real Estate</u> – cont.'d.

Peter carries out freeze of F Opco and F Holdco.

F Opco frozen for Mary and family.

F Holdco frozen for Mary (and family) and Paul (and family), using trusts.

Peter considers this fair.

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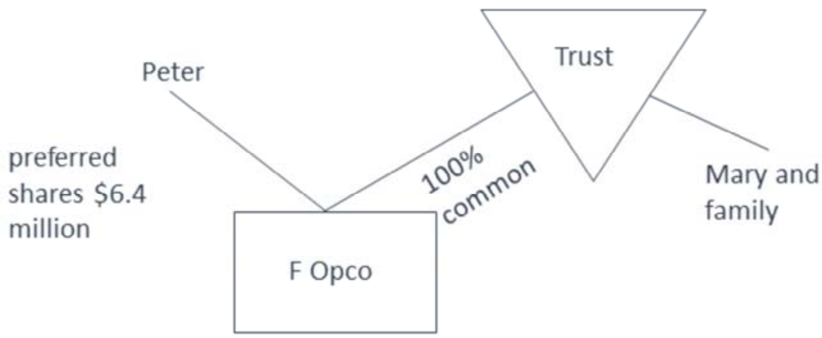
Peter's idea is to transition F Opco to Mary, to recognize that she has been actively engaged in the business, and to transition F Holdco to Mary and Paul recognizing that they are family members. Given this, and to be fair to Paul, it will be important to pay a reasonable fair market value rent.

His idea is to do this as a freeze and be paid over time.

Succession of the Family Business

Butterfly Real Estate – cont.'d.



One way to transition F Opco to Mary is to carry out a freeze. Peter reorganizes his shares of F Opco into preferred shares worth their fair market value, here $6,400,000, and then a trust is established for Mary and family. This trust obtains the common shares. Exactly how it obtains the common shares (by gift or by share subscription) is discussed later.

Succession of the Family Business

Use of Trust

Pros

Control, Peter can be 1 of 3 trustees

Financial, Peter can be beneficiary

Multiply capital gains exemption

Pass on in 21 years (maybe to grandchildren)

Can include minors, but caution

Family law protection

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Whether or not a trust is used in the estate plan depends on an evaluation of a number of factors. It would be typical to use a trust, but these various factors should be considered.

In favour of using a trust are the following points:

1. Peter will have more control with a trust, since he could be the sole trustee of the trust (if he is not a beneficiary) or could be one of three trustees(if he is a beneficiary).
2. Peter can be a beneficiary of the trust, if it is structured properly, which could be advantageous in that it gives him the opportunity to continue to be an owner in F Opco should he require financial resources in the future.
3. Using a trust could multiple the capital gains exemption among the various beneficiaries, including children (possibly minor children) depending on how the trust is structured
4. With the trust, a decision can be made in 21 years (before the 21 year rule applies) to transition the common shares to the next generation (maybe to grandchildren) or all to Mary.
5. Although the trust can include minor children, care must be taken concerning the application of section 74.4 (discuss later).

The trust will offer a certain amount of creditor protection and also family law protection for Mary, particularly if the trust is funded with a gift of the common shares made after marriage.

Succession of the Family Business

Use of Trust

Cons

Less control

Peter not owner or potential owner of growth shares

Need to decide shareholdings now

Possible income splitting at age 24, excluded shares if no trust

Less family law protection

If a trust is not used, then Peter will have less control. Also Peter will not be able to be an owner or a potential owner in the growth of F Opco, unless he remains a shareholder.

It will be necessary to decide the shareholdings now (for example 100% to Mary)

It may be possible to income split with children who are not actively engaged in the business, once they reach age 24, if no trust is used. But they need to be shareholders now. (Possibly shares could later be distributed from the trust to children age 24 for income splitting.)

In summary, the main factor which does not favour a trust is potential income splitting using excluded shares. However, on virtually every other factor, the use of the trust is advantageous.

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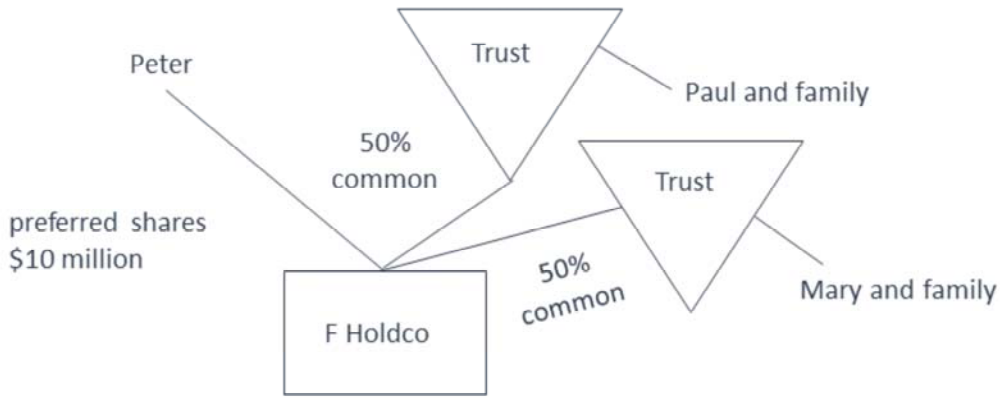
Butterfly Real Estate – cont.'d.



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Peter carries out the same type of freeze with F Holdco, except that there are two trusts, one for Paul and his family and one for Mary and her family. This recognizes Paul as a family member, making him a future owner, in the interest of maintaining fairness among the children.

Succession of the Family Business

Butterfly Real Estate – cont.'d.

Rental income to F Holdco is active income (associated).

No tax to set up structure.

Peter has capital gain on hand of $16.4 million. Tax about $4.1 million.

Value	$ 16.4 Million
Capital Gains Exemption	$ (.9)
	$ 15.5 Million
Tax 26.5%	$ 4.1

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Because F Opco and F Holdco will be associated, the rental income earned by F Holdco will be considered active business income. Whether or not it qualifies for the small business deduction will depend on other factors and limitations, and probably it will not.

The entire arrangement does not require any tax payment to establish. However, Peter still has a capital gain on hand, of around $16.4 million. The tax would be around $4.1 million. (It may be possible to obtain some further tax discount for the latent tax on the building, which could reduce the value of F Holdco. This has not been considered but in practice, it should be.)

Peter should be able to claim the capital gains exemption, approximated here at $900,000. Even after this, he has substantial tax to pay. Around $4.1 million, if he were to pass away or sell his preferred shares.

Succession of the Family Business

Butterfly Real Estate – cont.'d.

Peter (age 67) wants $500,000 per year pre-tax to fund lifestyle.

How to pay Peter?
Two basic approaches
Freeze/redemption plan
Capital gains plan

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Assume that Peter is age 67, and wants $500,000 per year pre tax to fund his lifestyle. The questions is how to pay Peter as part of the succession of the family business.

There are two basic approaches which can be considered. The first is an estate freeze and share redemption program. The second is a capital gains plan. Both of these are illustrated.

Succession of the Family Business

<u>Butterfly Real Estate</u> – cont.'d.

1. Pay dividends on preferred shares.

   3.1% Dividend
   $16.4 Million x 3.1% = $500,000

   Produces eligible dividend, tax at 39% each year.

   Peter's capital gain remains.

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Peter could be paid dividends on the preferred shares. At a value of $16.4 million, a dividend of 3.1% (roughly) would produce a $500,000 dividend. The dividend would be an eligible dividend, taxed (at least mostly) at around 39% each year. Paying a dividend to Peter each year would fund his cash requirements, but his capital gain would remain unaltered.

A lot of tax is paid.

Succession of the Family Business

Butterfly Real Estate – cont.'d.

2. Redeem $500,000 of preferred shares each year.

   Produces eligible dividend, tax at 39%.

   But gradually reduces Peter's capital gain.

   Over 20 years (Peter now 87), capital gain reduced by $10 million.

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Alternatively, Peter could redeem $500,000 of preferred shares each year. This would produce the same eligible dividend, taxed at 39%. But over time it would gradually reduce Peter's capital gain on hand. Over a period of 20 years, the capital gains would be reduced by $10,000,000. Peter would have to determine if he redeemed shares of F Opco or F Holdco, or some combination. The important point is that gradually over time Peter's capital gain is reduced, and potentially could be eliminated in the fullness of time.

The share redemption program is far superior to simply paying dividends on preferred shares, because of the reduction in the capital gains on hand.

But the dividend alternative is expensive.

Succession of the Family Business

Butterfly Real Estate – cont.'d.

3. Peter sells F Opco shares to MaryCo for note for $6.4 million.

   Peter has capital gain $6.4 million.

   Peter claims capital gains exemption of $900,000 (approx.).

   Capital gain (taxable) $5.5 million.

   Tax $1.46 million.

   Compare to dividend at 39%, tax would be $2.5 million. Savings $1 million.

   Can spread capital gains tax over 5 years.

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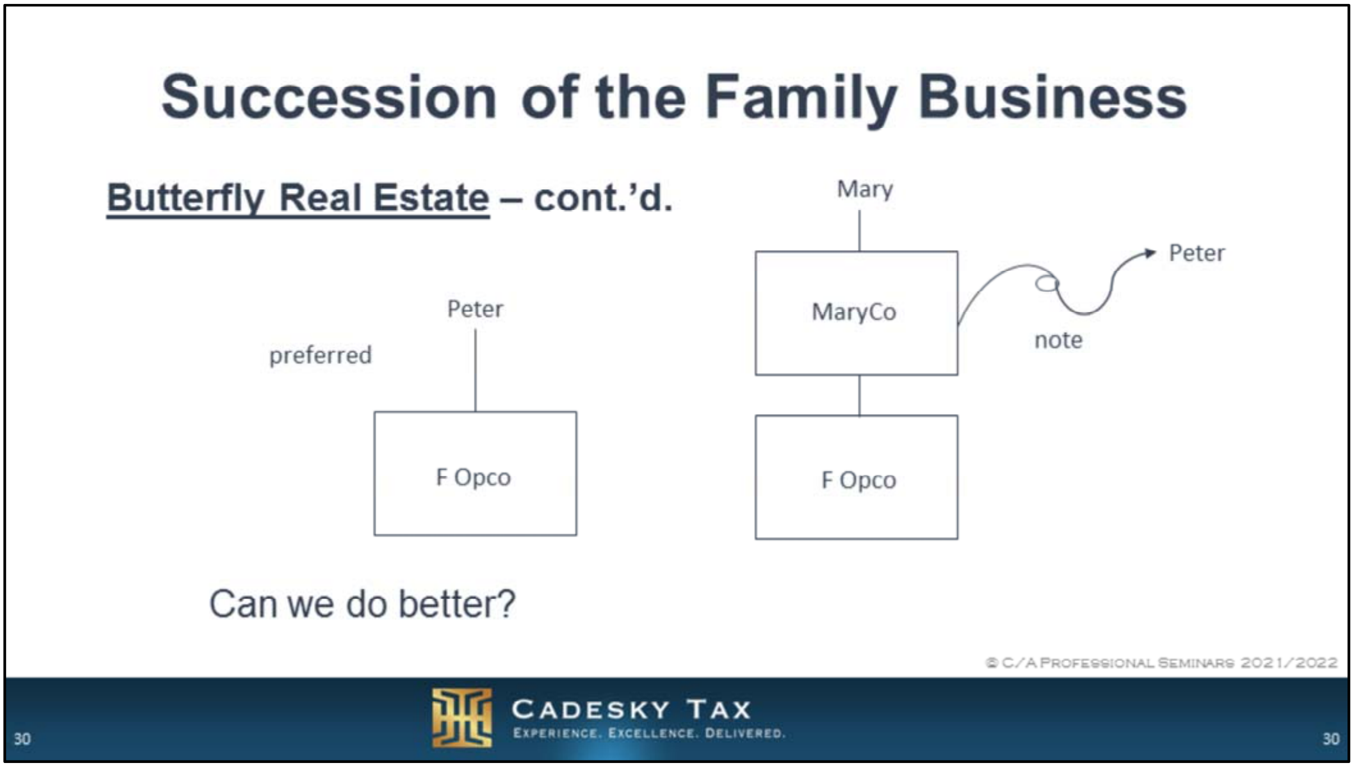
The other alternative is for Peter to sell the shares of F Opco to Mary or a company established by Mary (Mary Co) and recognize a capital gain. If sold to Mary Co, a capital gain of $6.4 million would arise, against which the capital gains exemption could be claimed (subject to the new rules concerning section 84.1 reviewed later). His capital gain would be $5.5 million after capital gains exemption and tax of roughly $1.46 million would be paid.

Compared to paying tax on a dividend of 39% which would produce tax of around $2.5 million, this results in a substantial savings (around $1 million). Also, because he is being paid over time, the capital gains tax can be spread over five years. He must recognize at least 20% of the gain per year.



This illustrates how the transaction might be carried out, with Mary Co owing Peter $6.4 million initially. F Opco can fund a payment with dividends to Mary Co, to pay Peter over time. This is very effective overall for the family, since Peter's capital gain can be paid from corporate funds. Again, careful attention must be paid to section 84.1.

This shows the difference between family business succession and an arm's length sale. Here we care about how the payments are funded. It is very advantageous to fund from F Opco's after tax earnings.

Succession of the Family Business

Butterfly Real Estate – cont.'d.

4. Peter sells F Opco preferred shares to Mary for note payable over 10 years.

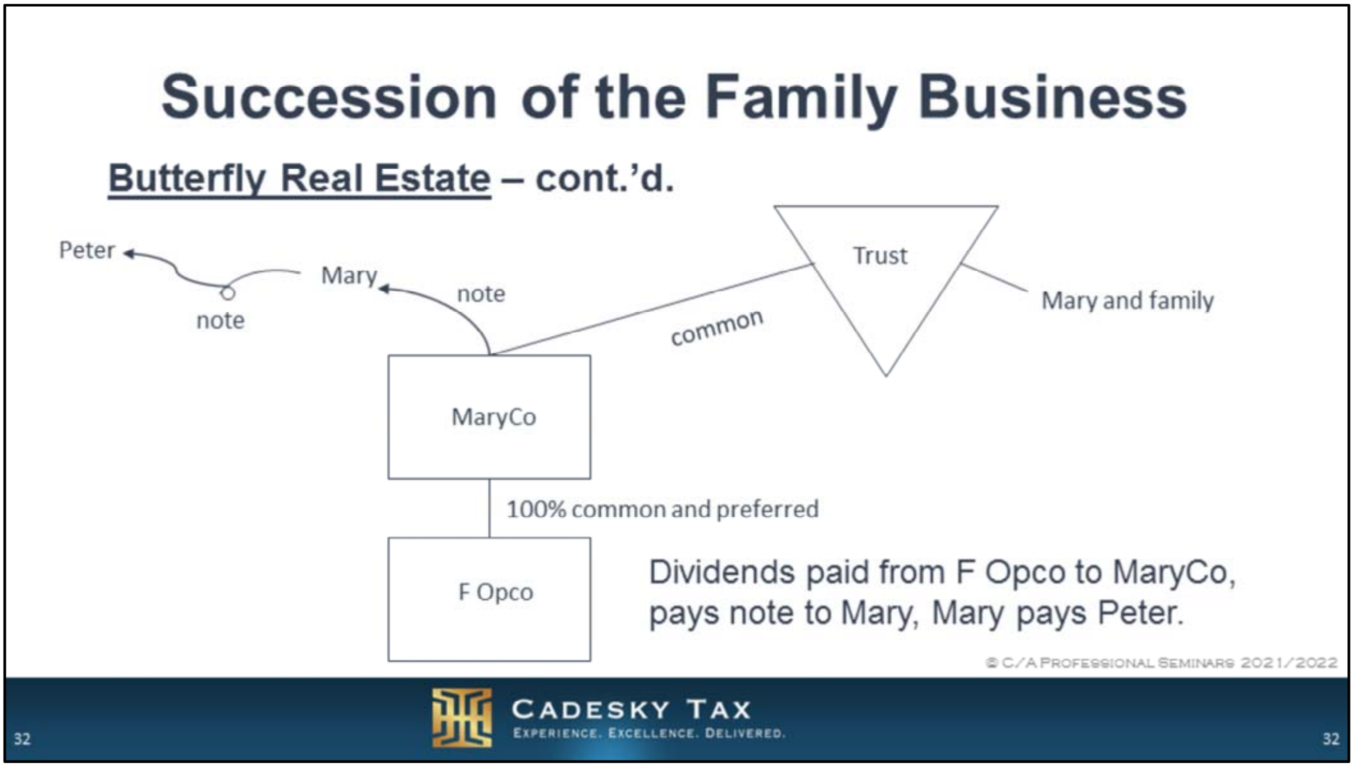
   Peter has capital gain as before but now can recognize over 10 years, not 5 years.

   Closer matching to cash flow needs.

   Mary transfers F Opco preferred shares to MaryCo for note for cost of $6.4 million.

   Mary also holds common shares through MaryCo.

Another alternative is available which will spread the capital gain over a 10 year period. Instead Peter sells the F Opco preferred shares to Mary for a note which is payable over 10 years. Because Peter is selling shares of a small business corporation to a child, the capital gains reserve is allowed over a 10 year period, which postpones the tax. It also matches the cash flow more closely to Peter's needs. Upon purchasing the preferred shares of F Opco from Peter, Mary transfers the preferred shares (which have a high cost base) to Mary Co for a note. Mary Co then receives dividends from F Opco, pays Mary gradually on the note and Mary pays Peter.



This diagram illustrates how the arrangement would work. The main difference between this and the previous alternative is that the note is owed by Mary Co to Mary who receives payments and who pays Peter over time.

Succession of the Family Business

<u>Butterfly Real Estate</u> – cont.'d.

In 10 years, Peter continues the plan with F Holdco preferred shares in similar way.

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The previous slides assume that Peter carries out the plan with F Opco for the first say 10 years, and then continues with F Holdco. However, in practice both could be done together, with payments coming to Peter from both sources. This might be fairer to Mary.

Succession of the Family Business

Some Observations

1. If new section 84.1 exception applies (assumed in example), no issue with plan. No dividend results.
2. If new section 84.1 exception DOES NOT apply then use of capital gains exemption and extraction of corporate funds for Peter or Mary produces ineligible deemed dividend (tax 47.74%). Also a straight sale of shares for a note results in entire note being ineligible deemed dividend (not just capital gains exemption part). A lot rests on this.

If new section 84.1 does not apply, because of the new amendment, then the plans shown before can proceed. No dividend would result.

Under section 84.1 before the amendment, if Peter sold directly to Mary Co, regardless if whether he claimed the capital gains exemption the resulting proceeds would be deemed to be a dividend. The dividend is, by specific operation of the rule, considered to be ineligible. Thus he would pay approximately 47% tax on the transaction, instead of paying 26.5% in tax which would be the rate on the capital gain. In addition, all of the tax would be payable immediately, instead of being able to spread the gain over 5 years or 10 years.

It is one thing if the amount represented by the capital gains exemption is recharacterized as an ineligible dividend, and another if the entire gain (Say $6.4 million) is an ineligible dividend. Therefore, until experience has developed with the amendment to section 84.1, caution should be exercised to minimize the possible adverse implications.

Succession of the Family Business

Some Observations – cont.'d.

3. If minor children can benefit under the trust, imputed income to Peter at prescribed rate times value of preferred shares. At 1%, deemed interest income to Peter is $164,000 per year. Prescribed rate floats per quarter; at 2% $328,000, etc. Exception if small business corporation.

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Section 74.4 can apply where an estate freeze is carried out and the common shareholder is a spouse, or a non-arm's length person under the age of 18. Where a trust is used, the rule will apply if any of these persons are beneficiaries under the trust.

In this example, if section 74.4 were to apply, there would be an imputation to Peter at 1% (currently the prescribed rate) on the value of the preferred shares. This would impute interest income to him of $164,000 per year. For this purpose, the prescribed rate floats, so if it were to increase, say to 2%, then the income inclusion would be $328,000 per year. This could be significant. Thus some approach must be taken to make sure that section 74.4 does not apply.

There are three basic approaches, none of which are perfect. The first is if Peter receives dividends on the preferred shares at least equal to the amount of the imputation on a grossed up basis. Unfortunately for this purpose, a dividend created by a share redemption does not count, and therefore Peter would actually have to receive a dividend paid on the preferred shares. In this circumstance, that is not a desirable result.

The second alternative is to make sure that no person under the age of 18 (and no spouse although not relevant here) can benefit under the trust while Peter is alive. This is the approach which is usually taken, but it would preclude use of the capital gains exemption among Mary's minor children.

The third exception is that the rule does not apply at a time when the corporation is a small business corporation. The problem with this is that it is possible that F Opco and/or F Holdco could cease to be a small business corporation at some point in the future, and then the imputation rule would begin to apply.

In conclusion, while there are choices available, no course of action is without drawbacks.

Succession of the Family Business

Some Observations – cont.'d.

4. F Opco must be a small business corporation at time of transfer. May need to purify first before transaction.

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F Opco must be a small business corporation at the time of the transfer. This may be important for Peter to claim the capital gains exemption, assuming that the exception to section 84.1 applies. Also, it is vital to claiming the capital gains reserve over a 10 year period. It might be necessary to first carry out a purification of F Opco, if it has, for example, surplus cash.

Another planning technique, not illustrated here, is a safe income strip to take out the retained earnings of F Opco before the transition to other family members. This can be beneficial in reducing the capital gain which would arise on transition of the business, but it comes at the price of potentially recognizing a dividend at a future time, at a personal tax rate higher than the tax rate on a capital gain.

Succession of the Family Business

Peter, Paul and Mary – Part 2

Suppose real estate is not used in an active business but rented to arm's length tenants.

Butterfly reorganization done as before.

Peter wants to freeze F Holdco as before.

How should Peter take out $500,000/year pre-tax?

Now F Holdco under RDTOH system.

Capital gains exemption may not be available.

Suppose facts in the case study are varied so that the real estate is not used in the active business of F Opco, but instead is rented to arm's length tenants.

The butterfly reorganization can proceed as before, although it would now clearly be an A type butterfly and would not qualify as a B type butterfly (because there would be two types of assets, business assets and investment assets and they would not be distributed proportionality).

In this situation, F Holdco would then be taxed under the RDTOH system. It is not productive to trigger a capital gain on the shares of F Holdco, when the income is not active business income. Thus, the share redemption approach would be favoured, and the capital gains approach would not be feasible.

Note also that F3 Co (before the butterfly) would not be a small business corporation. The butterfly may prevent the capital gains exemption from being used. But it will be a small business corporation post butterfly for claiming the 10 year reserve on F Opco shares.

Succession of the Family Business

Peter, Paul and Mary – Part 2

Do same plan as before for F Opco

No point in creating capital gain on transfer of F Holdco shares. Ineffective because of RDTOH system.

Need dividend to get dividend refund.

The reason the capital gains approach is not feasible when a company is governed under the RDTOH system, is that it is necessary to pay a dividend in order to obtain a dividend refund, and so optimize the tax position of the corporation and the shareholder. If a dividend is paid and it exceeds the ratio for the dividend refund, double tax will result. Also, if a capital gain is created at the shareholder level, this will also lead to double taxation.

The planning for F Opco can proceeds as before, but the planning for F Holdco needs to now be tied to the income of the company and the amount of dividend which will create a dividend refund.

Succession of the Family Business

F Holdco Income

Rent	$ 400,000
Depreciation	assume nominal
Taxable Income	$ 400,000
Tax 50.2%	$ 200,800
RDTOH	($ 122,667)
Net Tax	$ 78,132

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Assuming that the net rental income and taxable income are $400,000 per year (depreciation ignored here), then the corporate tax would be just over $200,000. The dividend refund, upon payment of an ineligible dividend would be $122,667. This results in net tax of $78,132 which is about 20%.

Succession of the Family Business

F Holdco Income – cont.'d.

Dividend	$ 320,000

(produces dividend refund of $122,667 with small excess in F Holdco).

Dividend is ineligible	
Tax $320,000 x 47.74%% =	$ 152,768
Peter's after tax income	$ 167,232

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The dividend necessary to realize the full dividend refund is $320,000, which leaves a small excess in F Holdco each year.

The personal tax on the dividend would be around $152,000. Peter's after tax income would then become around $167,000, far less than in the previous case, where he is not limited in the amount of the share redemption, because the rental income is taxed as active business income.

Succession of the Family Business

F Holdco Income – cont.'d.

Vastly different from previous result.

Peter takes funds by redemption of preferred shares.

Based in these numbers, a vastly different result arises, with the amount Peter takes out by redemption of the preferred shares being significantly lower than what might otherwise be the case if the income was active.

He can still use the capital gains plan for F Opco.

Succession of the Family Business

F Holdco Value Over time					
Year	Preferred	Common	Income	Tax	Redemption
1	10,000,000	---	400,000	78,132	320,000
2	9,680,000	320,000	400,000	78,132	320,000

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If the value of the preferred shares initially is $10 million, and $320,000 is taken as a share redemption, producing a dividend of this amount, then at the end of the first year, Peter's shares are now worth $9,680,000. This continues for a number of years, ultimately resulting in all of the preferred shares being redeemed by year 33.

This is a very long holding period, and Peter would be 100 years old before it is completed.

Succession of the Family Business

F Holdco Value Over time					
Year	Preferred	Common	Income	Tax	Redemption
11	6,800,000	320,000	400,000	78,132	320,000
21	3,600,000	6,400,000	400,000	78,132	320,000

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F Holdco Value Over time					
Year	**Preferred**	**Common**	**Income**	**Tax**	**Redemption**
31	400,000	9,600,000	400,000	78,132	320,000
32	80,000	9,920,000	400,000	78,132	80,000
33	---	10,000,000	---	---	---

Succession of the Family Business

Takes 33 years to fully redeem preferred shares. Peter is age 100!

In practice, rent will increase over time shortening the period.

Need to model.

Better to redeem shares of F Opco or F Holdco?

In practice however, the rent will increase over time, which would shorten the period for the redemptions. This needs to be more carefully modelled, to determine the overall outcome.

One question which arises at the outset which is whether it is better to redeem the shares of F Opco or F Holdco.

If Peter adopts the redemption route with F Opco, then he should use this as a source to “top up” the amount of his redemption, and it would be preferable for him to first take the redemption from F Holdco in order to trigger the dividend refund.

Succession of the Family Business

Formula

v value of preferred shares

r return on rent as % of value of preferred shares

t tax rate net of RDTOH

y number of years of redemption to complete

Annual redemption amount $v \times r\,(1 - t)$

Percentage of value per year. $\dfrac{v \times r\,(1 - t)}{v}$

This slide provides the algebra for determining the period of the redemption. The value of the preferred shares is v. The return on the rent is a percentage of the preferred shares (being a proxy for the value of the property) is r.

The tax rate, net of dividend refund, is t. The idea is to determine the value for y, being the number of years that the redemption program must be carried out until it is complete.

The annual redemption amount is v x r adjusted for the after tax rate which is 1- t with t being the tax rate

The percentage of the value per year is obtained by dividing by v, the value of the preferred shares.

Succession of the Family Business

Formula – cont.'d.

Simplified to r (1 – t)

if r is 4% and tax rate 19.5%

then .04 (1 - .195) = .04 x .805
= .0322

Number of Years: 1/.0322 = 31 Years

Based on simple algebra, v is eliminated from the equation, which simplifies the formula to r(1-t). If r is 4% and the tax rate net of dividend refund is 19.5%, then the amount of value redeemed in a year is 0.0322. Put into percentage terms this is 3.22%. The number of years is the reciprocal, or 1 /.0322 which is 31 years.

Succession of the Family Business

Rate of Return	Number of Years
3%	41
4%	31
5%	25
6%	21
7%	18

Very dependant on rate of return.

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This slide shows a table of the number of years against the rate of return. For example, if the rate of return on the real estate is 3%, the redemption period is 41 years. If the rate of return is 7%, then the redemption period is 18 years.

It can be seen that the period of redemption is very dependent on the rate of return.

Succession of the Family Business

Failure to match RDTOH to dividend on redemption results in double taxation.

Failure to fully redeem all preferred shares before death leads also to potential double taxation.

Need to consider implications and what other alternatives exist.

Possible plan 1st year of estate is to sell real estate or at least sell some fraction.

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To recap, redeeming shares but failing to match the dividend refund results in double taxation (over stripping the dividend). In addition, the failure to redeem all of the shares before death leads to potential double taxation, once at the shareholder level, and again when the real estate is sold with tax being paid at the corporate level.

It is necessary to carefully consider the implications and what other alternatives exist, particularly to speed up the redemption program.

If Peter does not complete his redemption program during his life, then it is possible to have one last opportunity in the first year of the estate. Rather than face double taxation, it may be preferable to sell the real estate or at least sell some fraction of the real estate in some fashion. For example, the real estate could be transferred to a subsidiary, and a gain of the appropriate amount triggered in order to create capital dividend and RDTOH to complete the redemption program.

Succession of the Family Business

Refinements

1. F Holdco shares worth less than real estate itself due to tax discount.

   A discount of 20% (not realistic too high) changes return from 4% to 5% ($400,000 rent to $8 million value) and shortens period to 25 years.

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There are a number of refinements through the model, which can make a significant impact. Firstly, a discount can be taken in the share value of F Holdco, for the underlying tax when the real estate is sold, and also costs of disposal. If we assume that the discount that will be taken is 20%(which in reality is likely significantly too high), this would change the rate of return on the preferred shares from 4% to 5%. $400,000 net rent would be compared to $8,000,000 of value rather than $10,000,000 of value. This would shorten the redemption period to 25 years.

The amount of tax discount needs to be supported by a valuation.

Succession of the Family Business

Refinements – cont.'d.

2. Use of alter ego trust and off calendar year-end of F Holdco could add 4 more taxation years of F Holdco for redemption.

   Now period is 21 years pre-death plus 4 years after. Becomes more realistic. Peter would be 88 years old.

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It is possible to get further years of redemption, through using an alter ego trust. Note that a capital loss on an alter ego trust can be carried back for up to three taxation years.

This capital loss arises because:

- A capital gain results in the alter ego trust at Peter's death so the preferred shares now have an ACB of FMV
- The final redemption produces a capital loss which can be carried back

Having an off calendar year-end of F Holdco could add one more year, so potentially 4 additional years of share redemption could be achieved if Peter held his shares through an alter ego trust. Now the period of redemption during Peter's lifetime is 21 years plus four years afterwards, which starts to look more achievable.

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Refinements – cont.'d.

3. Even modest increase in rent (say 3% per year) makes big impact.

Rent in year 20 now $722,000 (3% increase per year).

Approximate average / year $561,000.

Rate of return on $8 million is 7% on average.

Now period is 18 years. Deduct 4 years with alter ego trust, now 14 years. Peter is 81.

It is not realistic to assume that the rent will remain the same forever. A reasonable assumption would be that rent would increase by say 3% per year. Although this looks modest, it actually makes a major impact on the numbers. The average rent is now $561,00 per year ($400,000 in the first year, but increasing to $722,000 by year 20). If the preferred shares are worth $8,000,000 (discounted), then the rate of return averaged over 20 years is about 7%. Now the redemption period is dropped to 18 years.

With 4 years being possible after Peter has passed away, this now requires a period of 14 years during Peter's lifetime, at which point he will be 81 years old. This looks significantly better.

One important point though is not to leave the redemption program for too long. It is better to begin the redemption program earlier, and allow for a longer period of redemptions.

Succession of the Family Business

Reversible Freeze

Peter can be a beneficiary of freeze trust.

Then eliminates issue of freeze too early.

Time horizon. In 21 years, prepared to pass on ownership.

If yes, trust distributes to children. If no, trust distributes to Peter. Might be a combination.

Determining when to begin a freeze program as part of a transition of a business depends on a number of factors. If Peter had a spouse, then the joint life expectancy of him and his spouse is longer than his own life expectancy. It will also depend on his personal wishes, his views on transitioning the business to children, his own financial resources and so forth. However, if one works with a time horizon of say 21 years, and Peter becomes a beneficiary of the trust used in the freeze, this may help to encourage Peter to begin the plan. One fear that many people have is that if they freeze to early, they may run out of funds. But if the parent is a beneficiary of the trust(which could apply in the case of Peter), then the trust can continue for 21 years before a decision has to be made about where the common shares will go. If at the end of 21 years, Peter is comfortable, then the shares can be distributed on a tax free basis to the children. If Peter is not comfortable at that point, then possibly the shares or a portion could be distributed to Peter.

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Reversible Freeze – cont.'d.

Need to plan early to carry out redemption program for real estate investment company.

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It is definitely important to carry out the redemption program at a reasonably early time (say age 65 or thereabouts) for a real estate investment company.

Even at age 65 it may be challenging to complete the redemption program.

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Reversible Freeze – cont.'d.

Can transition active business later (less sensitive to timing)?

May use capital gain plan instead of freeze/redemption plan.

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It is less important with respect to an active business, because redemptions do not need to be matched to dividend refunds. Also, Peter can instead consider the capital gains plan as an alternative. It is also possible to carry out a combination of both.

The capital gains plan is most effective with a 10 year time window.

Succession of the Family Business

Other Aspects

- Limits to discretion of discretionary trust.
- Family law considerations.
- Maintaining control.
- Should there be a shareholders agreement.
- Issues if Peter a beneficiary.

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Peter should not assume that with a discretionary trust, he can simply do whatever he wants. Although the trust would be structured to be discretionary with Peter as a beneficiary in addition to say Mary and possibly her children, it would be wrong to assume that Peter can direct what will occur in 21 years. The trustees of a discretionary trust cannot exercise discretion in any way they choose, on an arbitrary basis. They need to consider what is appropriate and in the best interests of the beneficiaries. However, if the trust is properly drafted, then Peter can have a high level of assurance that his wishes will be adopted, particularly if he is one of the trustees.

Family law considerations are important. Suppose a family member subscribes to common shares of F Opco and F Holdco and then contributes these to trusts for Paul and Mary. If they have spouses at that time then this can be structured as a gift after marriage which, together with suitable provisions in the trust agreement, carries with it significant family law protection.

If Peter wants to maintain control over F Holdco and F Opco, there are a number of ways that he can do so. Firstly, he can hold a class of special voting shares, along with the frozen preferred shares, which will give him de jure or legal control. Secondly, the common shares could be made non-voting. Thirdly, he could be one of the trustees, and possibly have an additional power under the trust agreement to replace the trustees with other persons who may be favourably disposed to him.

There can also be added protection from a shareholders agreement, which would be especially useful if a trust was not used.

It should be noted that if Peter is a beneficiary of the trust, he can not be the settlor or contributor of property to the trust, nor can he be the sole trustee, otherwise subsections 75(2) will apply with adverse consequences.