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ESTATEPLANNING

All In the Family

Make A Family Participation Plan

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Planning for high-net worth family businesses is so important - if only parents could get along with their adult children, siblings could stop sniping at each other and cousins could stop vying for attention.

Jeff Noble, director, Business & Wealth Transition at BDO Canada LLP, will tell you that about 70 per cent of intergenerational wealth transitions fail because of familial anger, bickering and distrust. Even if a family-owned business does make it to the next generation, 70 per cent of those will end up being dissolved.

That's a lot of money and a lot of potential business future that will simply disappear if left unchecked. According to a CIBC report, 51 per cent of Canadians expect to transfer wealth, but 47 per cent have not discussed the inheritance with the recipients. When you realize that some 80 per cent of companies in Canada are family owned, that's billions of dollars of potential intergenerational wealth that has gone up in smoke.

While a downturn in the economy or a bad business plan can lead to the demise of a family company, the truth is that more than half of these failures are due to a breakdown in trust and lack of communication both between and among the generations.

Our work with private company owners and their families usually involves a talk about succession planning, a process that accounts for the transition of management, leadership, ownership, and control. To get all of these in motion, family members must get along and get aligned on the future of the business and their financial future.

Have a Succession Plan

According to the Canadian Federation of Independent Business, only nine per cent of business owners have a formalized, documented succession plan. About 40 per cent say they have "some sort" of informal plan, leaving just over half with no plans at all.

That's a huge issue when most private companies have anywhere from 80 per cent to 90 per cent of their owners' family net worth and lifestyle income dependent on their business.

Succession planning means making decisions in accordance with all the other disparate members of the family. But for that to work, there must be an understood strategy in writing. There is a lot of conflicted thinking and conversations. As a result, we find that these business owners are afraid and uncertain as to how to move forward, which leads to procrastination. Unless and until they get some understanding as to what is holding them back, it's difficult to move forward.

A prime example of con-

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flicted interest occurs when a parent wants the oldest child to come into the family business after he gets his MBA. Meanwhile child #2 cannot find a job and the owner is convinced by his spouse to give him a job as well. Are either – or both – of the adult sons committed to continuing in the business?

"What we're looking to do here is see where there is and where there isn't alignment – but without good positive communication and alignment, it could be difficult to go forward," says Jeff.

Family Participation Plan

A helpful start is the adoption of a Family Participation Plan, conversations with the parents and adult children, whether they are working in the business or not, to determine what each one wants to get out of the business. Over the years, the business has supported the entire family, put all the children through university, even helped them buy their first homes. Unfortunately, trouble typically ensues when family members have different plans for themselves or the business.

Take this example: A mother, in her early 60s wants to retire soon and decides to sell her company to the two children working in the business. The woman, who received her shares from her father, has put her intention to leave her shares to the two children on paper, backed up by lawyers and accountants. When she convenes a family meeting about the business, the non-involved children are angry because they feel they have been left out of an opportunity.

Meetings like this can get ugly and people say things they later regret. It's situations like these when Jeff and other Family Enterprise Advisors are called in to turn a nasty state of affairs into a workable plan.

Planning is essential in family-owned businesses. With professional planning, tempers often cool down when people see how the financial side enables everyone to get something. We tell families that on the death of a business owner, there is no tax liability if the money goes directly to a surviving spouse. With no surviving spouse, millions – literally -- may be needed to clear the tax-department debt.

The money for Canada Revenue Agency can come from the owner's bank account or else some of the assets of the company can be sold. A recent case involved a grandfather who did not believe in life insurance -- or any kind of planning. When he died, the estate was forced to sell two apartment buildings to pay the tax. Taxes erode a lot of intergenerational wealth.

In another recent case, a company started by a young couple in the 1960s with a small $1,000 investment slowly grew to $10 million over 50 years. But when the second spouse died, the tax department wanted to collect 26 per cent of the difference between the original $1,000 and $10 million, or $2.6 million. The family could have paid the tax bill with any cash on hand, or borrow the funds, sell part of the business, dispose of other assets – or buy life insurance. In most situations, buying life insurance is the least expensive and most tax-effective method to ensure available funds to pay taxes and the sustain the future of the company and family wealth.

Proper planning is not a one-step, day-long meeting, especially when the futures of multiple stakeholders are on the line. The challenge comes when structures get put in place ahead of when the family actually settles on a plan.

Treat Your Children Well

The main issue with owners of family businesses is that they want to treat their children and grandchildren – whether in the business or not – in a fair and equitable way to ensure they each get financial independence.

We sometimes have had family-run corporations where the parents want to leave an equal number of shares to each child. This makes it difficult for the adult child running the business. While all the children may want a financial part of the business, they may know little or nothing about how it is run, changes that may be made in the future and the kinds of employees needed.

To solve that problem, we often set up a plan that leaves the entire business to the adult son in the business and use life insurance proceeds for each of the other children as their fair share of the business.

We usually recommend setting up a Family Advisory Board for the business. This is a collaborative effort between parents and their children to get some non-family people involved on the advising side. A neutral third party works well in a family setting, and significantly improves the odds of success.

Even though it's all in the family and a private corporation, it's important to get a shareholder's agreement to ensure the future ownership of the company.

A buy-sell agreement makes it clear how shares will be transferred when a partner retires, becomes disabled, dies, goes bankrupt or has a marriage breakdown.

Another case involved two brothers in their mid-40s who own a business valued at $20 million. Neither of them thought about what would happen if they couldn't open the front door of their business if one died or became incapacitated. If you were the surviving shareholder would you want your surviving sister- or brother-in-law and his/her lawyer as your new partner?

Estate Freeze

An estate freeze can be tax advantageous in passing along the future growth in the value of the company to children.

Take the example of two sisters, age 65 and 60, who are equal shareholders in a company. They have a shareholder's agreement outlining the buyout requirements if one of them dies. The senior sister wants to retire at age 75. She puts in place an estate freeze to lock in the value of her shares so she can do tax planning now, using life insurance to fund the tax liabilities of her estate. This way she can pass all the future growth of her shares to her son, who is currently working in the business. Remaining children will be able to use the life insurance benefits.

Another focus deals with risk management and the steps business owners can take to help mitigate risk. Many owners believe they have great control and great returns from their business. But what they do not understand is that they have absolutely no control over interest rates, foreign exchange and a variety of other factors outside of their business.

Many business owners haven't been hit directly with charges like tariffs – but they usually know someone who has. When COVID-19 hit, most business owners realized they didn't have as much control as they thought they had.

We encourage business owners to diversify their wealth, away from their business, over time, and make them aware of the risk to family wealth and the benefits of diversification.

Best Practices

Life insurance can be a tax-effective leveraging strategy that allows the family enterprise to protect and grow their wealth, while enjoying tax deductions.

If the family in the business has enough wealth, they often use insurance as an investment on their balance sheet. For example, the cash surrender value (CSV) that builds in a tax-exempt whole life or universal life insurance policy can be used to reduce the costs of buying the policy. This is done through a strategy called an Immediate Financing Arrangement (IFA) that basically uses an insurance policy as collateral for a line of credit with a Canadian bank. The money from the loan can go into your investment portfolio, business, or property to produce income.

A corporate IFA can also increase the size of your company's Capital Dividend Account. This account tracks certain tax-free surpluses that are accrued by a private corporation and may be distributed in the form of tax-free capital dividends to the shareholders of the corporation.

Another best practice is setting up a governance structure for the ongoing future of the family business. Governance is about creating mechanisms and solutions for families to get together and communicate in an open and safe environment, manage conflict and make decisions together.

The goal here is to look for alignment among the parties, find common goals, put structures in place and above all, deal with facts.

That means an equal voice for everyone – whether you are the long-time patriarch of the firm or an adult granddaughter fresh out of university coming into the business.

If, as and when families are able to move beyond past grievances and family conflicts during these kinds of meetings, sound discussions concerning the future of the family and the company tend to come together.

The past year has been seen more proactive actions than reactive ones because of COVID-19 and its effect on businesses. During strenuous times like these, family councils and other structures are put to the test. But with advice from knowledgeable professionals, it can be done.

If you are a business owner, please contact us for a no-obligation consultation. Our advisors across Canada are available to help you. ❑

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He guides successful business owners, professionals, and affluent families through the complex process of ensuring the people and organizations they care about are taken care of. If you are like his other clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy.

Mark collaborates with your professional advisory team to achieve your desired outcomes. His simple approach makes sure what is important to you gets done. He will suggest appropriate strategies to get your financial affairs meticulously organized, help you take action, and simplify the complicated so you and your family can rest easy.

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