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TAXSTRATEGY

Smart tax planning for

Family Business

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In more than 25 years' of professional practice focused on insurance and estate planning, we have developed a strong admiration for family businesses and their owners. They are usually diligent, hard-working, family-oriented people who inherited the family firm or built their own from scratch and want to pass it on to their children and future generations.

Family business owners are usually so busy working in the business, exploring new opportunities or managing staff that they miss some critical questions: What happens to the business if they get sick or die prematurely?

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What would they like to see happen at retirement or before? The short list of exit options: sell to a third party, pass along to family members or just shut the doors?

A noteworthy 80 per cent of companies in Canada are family owned, as reported by The Canadian Association of Family Enterprise. They range from the corner store to some of the country's most respected businesses. Collectively they generate revenues about $150 billion annually and account for about 70 per cent of Canada's employees.

Most family-business owners believe the ability to pass on their company to the next generation is very important. But in many cases, a tax liability prevents that from happening. That obstacle can be overcome with proper planning.

On the death of a business owner, there is no tax liability if there is a surviving spouse. The tax liability crystalizes when the second spouse dies.

How can a big tax liability arise?

This recent case is a good example of how a big tax liability can arise from the growth of a profitable family business. A company started by a young couple in the 1960s with a modest $1,000 investment slowly grew to an enterprise worth $10 million over a period of 50 years. Upon the death of the second spouse, the tax department will want to collect 26 per cent of the difference between $1,000 and $10 million, or $2.6 million. The family could pay the tax bill using cash on hand, or by borrowing the funds, selling the business, disposing of other assets, or using Life Insurance. In many situations, the least expensive and most tax-effective method to ensure that future ownership of your company remains in the family uses life insurance or other insurance instruments. Life insurance proceeds flow tax-free to beneficiaries and bypass probate. People buy life insurance because it is more cost effective and tax-friendly than other options, and can be used to pay future tax liabilities (for pennies on the dollar) or help lower current taxes.

Two wills

There are other issues to consider, that if not provided

for, should keep owners up at night. Many business owners often don't have a current will nor do they realize that they need 2 wills, both personal and corporate to avoid probate taxes which amount to 1.5 percent (in Ontario) of the market value of any asset not jointly owned.

Other business owners have a will that was cobbled together years ago, usually before leaving on a vacation, and haven't touched it since. It's important to review your will periodically from every angle, because a thorough inspection will reveal any crucial cracks that may have developed in your plans over the years.

Equal or fair?

Many family businesses don't involve every member of the family. I recently met with a couple whose business was worth about $30 million. Of three adult children in the family, only the son helps the father in the business. Father wanted to ensure that each of his children receives "equal" compensation when he and his wife pass away, so he made each of his children equal beneficiaries of the business.

This creates a problem: How can the brother run the business effectively when he is not the majority shareholder and his siblings, with little knowledge of the business, can veto his decisions? How do the two sisters feel about relying on their brother to make sure the business keeps going? The father considered "equal" and "fair" as synonymous, so the business succession plan may have been "equal", but not fair to any of the children. In the end, we implemented a plan that leaves the entire business to the son and life insurance proceeds going to each of the other children as their fair share of the business.

Shareholder Agreements

Family or not, if you own a share in your business with one or more partners in a private corporation, a shareholder agreement is an absolute must to preserve the future ownership of the company and articulate your succession plan.

A recent case involved two brothers in their mid-40s, who own a healthy business recently valued at $20 million. Neither of them had given any thought to what would happen to their thriving enterprise if they couldn't open the door of their business if one died or became incapacitated. Or, if one of the family shareowners dies, do you, as the surviving shareowner, want their surviving spouse, lawyer and other advisers as your new partners?

Many different structures are available for use in a shareholder agreement. Each has its own tax and legal outcomes. One structure provides for the surviving shareholder(s) to buy the deceased's shares, with the result that each shareholder is the owner and the beneficiary of a life insurance policy on every other shareholder. When one of the shareholders dies, the life insurance proceeds are paid tax-free to the surviving shareholders, who then use the proceeds to purchase the deceased's shares.

Buy-sell provisions in a shareholder agreement will make it clear how shares will be transferred when a partner retires, becomes disabled, dies, goes bankrupt or has a marriage breakdown. Your agreement can also stipulate that staff members are well looked after and retained by the business to ensure continuity and loyalty through difficult times. If the second shareholder wants to sell the business, you might put a stipulation in the agreement that the employees are kept on. You can also ensure that if there is a buyout, your key people will be able to receive some financial consideration.

Estate Freeze

An "estate freeze" is another common planning tool that business owners use for tax advantages and passing along the future growth in the value of the company to children.

Take two sisters, age 65 and 60, who are equal shareholders in a company and who have a shareholder agreement that deals with the buyout requirements if one of them dies. The senior sister wants to retire at age 75. She implements an estate freeze to lock in the value of her shares so she can do tax planning now, using life insurance to fund tax liabilities. This way, she can pass all the future growth of her shares to her son who is a senior manager in the business.

Family Trusts

"Family trusts" are often used for estate planning and the transfer of wealth from one generation to the next, especially if the parents own a business. They can also be very helpful in situations that involve minor beneficiaries or disabled family members. A trust, for example, can own and manage property through the trustee, preserving and investing the capital until the minor reaches the age of majority. It can also be used to

split income and as a form of creditor protection.

Individual Pension Plan

And finally, what happens to you when you retire? Now that people are living longer, a healthy retirement can last a very long time. Have you considered your personal exit strategy? Many high-income business owners have stopped using RRSPs and can now take advantage of a customized, high-performance vehicle known as the Individual Pension Plan, or IPP.

With an IPP, you lower risk and achieve a steady return of 7.5 per cent a year. If your investment returns fall below that 7.5 per cent averaged over three years, you can add tax-deductible top-up contributions to bring the plan back into line.

An IPP offers significant tax deductions to your corporation, such as investment and administrative fees. IPP assets are covered under provincial legislation that deals with creditor protection. While RRSPs restrict what you can, and cannot, put in the plan, IPPs are much more flexible, allowing you to include assets like shares of private businesses and real estate.

Less than 75 days to act

New tax rules will be implemented on January 1, 2017, so the time to take advantage of tax saving and investment opportunities using tax-exempt permanent life insurance is now. Because it takes about 90 days to complete the application and underwriting, the real deadline for action is October 1st, 2016, now less than 75 days away.

Taxes will continue to rise and the government will persist in eliminating and reducing tax saving strategies, so business owners (and all taxpayers) must be proactive to ensure they are getting the right planning advice and paying no more tax than necessary.

Don't do it yourself. Seek professional help. The best way to get financial peace of mind is getting advice from an impartial and experienced team that includes your accountant, lawyer and a Certified Financial Planner or Trust & Estate Practitioner.

Contact us for a no-obligation consultation or to get a second opinion on your current planning. ❐

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