Business Succession Planning

Learning Objective:

- Identify relevant estate planning objectives and considerations important to the shareholders of a private business.
- Align and explain retirement and estate planning strategies that address business owners' planning objectives.

The Facts

Hank is a successful businessman on the verge of retirement and has approached you for advice on how to best transition his personal and business assets to his family, both now and at the time of his death. A widower, age 63, Hank has amassed considerable assets, much of them associated with the unincorporated trucking firm that he has owned and operated for the past 22 years.

Hank has three children: two actively employed in his trucking business, Hank's Haulage, and one daughter, LeeAnne, 40, who is a nurse and is divorced with two children living at home. Hank's son Brent, age 38, has worked since graduating college as the office manager and dispatcher. Hank's other daughter, Karen, age 34, handles the long-haul jobs with one of the business's 18-wheelers. Brent and Karen would like to continue working in the trucking business as a career and envision taking over Hank's Haulage in the relatively near future. The three children all get along but none of them sees LeeAnne becoming an active participant in the business.

Hank has been grooming Brent and Karen to take over the business when he retires, but realizes that he cannot afford to simply hand it over to them. Aside from his modest RRSP and government benefits, Hank is counting on receiving a generous income, somewhere in the range of $170,000 annually, from the business to support him in retirement. On the other hand, the children do not have the resources to buy out the business just now, nor are they likely to be able to afford it in the near future. Hank is looking to you for a solution to the problem.

The physical assets of Hank's Haulage have a fair market value of $1,540,000, as depicted in Exhibit A.

Exhibit A

Hank's Haulage Asset Summary

ASSET	FAIR MARKET VALUE	ADJUSTED COST BASE	UNDEPRECIATED CAPITAL COST
Trucks	$600,000	$800,000	$520,000
Warehouse & Land	$800,000	$450,000	$320,000
Equipment	$120,000	$150,000	$135,000
Furnishings and Office Equipment	$ 20,000	$ 32,000	$ 18,000
TOTAL	**$1,540,000**		

Hank feels that he could probably get about $1,750,000 for the business and its assets on the open market, if he sold the business as a going concern.

Hank's accountant has been after him for years to incorporate the business, explaining the tax advantages that incorporation could offer, but Hank has never felt the need. He has run Hank's Haulage as a sole proprietorship since its startup and has been content to keep it that way. In addition to the business, Hank owns assets totaling $524,000 as shown in Exhibit B, and is debt-free.

Exhibit B

Hank's Assets

ASSET	FAIR MARKET VALUE (FMV)	ADJUSTED COST BASE (ACB)
House	$320,000	$160,000
Cars/Furnishings	$40,000	$65,000
RRSP	$80,000	$56,000
Investment Portfolio	$62,000	$56,000
Bank Accounts	$22,000	$22,000
	$524,000	

Hank presently has no life insurance, having cancelled his term policy shortly after his wife died. He is, however, in excellent health and is confident that he could qualify for a policy, if needed.

He is in a 45% marginal tax bracket, has never used any of his lifetime capital gains exemption and has not made any charitable donations this year. He has expressed to you that he wishes to minimize taxes (including probate fees) wherever possible, both now and at the time of his death.

LeeAnne's two children are Claude, age 21 and Irene, age 14. Hank is well aware of LeeAnne's limited financial circumstances and wants to ensure her financial security, and that of her children, to the extent that he can. Irene suffers from a genetic disorder and is unlikely to ever hold down a meaningful job. Claude has recently joined a radical religious sect. As a consequence, Hank is adamant that Claude should never be entitled to any of his estate unless he renounces the organization.

Hank has long been closely associated with a local community association, a registered charity, which has helped his children and grandchildren a number of times. He would like to offer a generous contribution to the association, perhaps as much as $150,000, if he could afford to. He could use the tax deduction now, but simply cannot afford to relinquish the income that the funds could offer him in retirement. Hank did not update his will or power of attorney following the death of his wife six years ago. His will and power of attorney were executed 20 years ago and named Hank's late wife as his legal representative and the sole beneficiary of his estate. In the event that she should predecease him, the will identifies his children living at his death, in equal shares per capita, as his successor heirs. He understands that his will is out of date and may need modification, particularly now that he has met someone new, Marge, and has a tentative date to remarry within the next year. Hank and Marge plan to celebrate his retirement by taking a round-the-world cruise.

Marge's spouse died three years ago, leaving her with few assets and substantial debts. A marriage to Hank will mean not only companionship, but the prospect of financial security for the rest of her life. Hank is comfortable with this arrangement and wishes to ensure that Marge has a good lifestyle in her later years, but is also very mindful of his obligations to his children.

Question 1

Explain four recommendations you would put forward to Hank that will help him meet his estate, financial planning and tax objectives in relation to his business, without negating another objective.

Solution

- First, Hank could incorporate an operating company to run Hank's Haulage. He would be the sole shareholder of the new company.

  Reference:
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 16.2.1*

- Next, he should transfer ownership of all of the business assets from himself to the newly incorporated company. This should be done on a rollover basis (at ACB or UCC), using a section 85 tax-deferred rollover. In this way he can transfer the assets (which do not currently qualify for the LCGE) without triggering capital gains or recapture of CCA. This would allow Hank to transfer the business assets into the newly incorporated company without causing any immediate tax consequences that would otherwise apply.
- By implementing an estate freeze of his common shares, Hank could accomplish four things:
  - Transfer all future growth in the value of the business to Brent and Karen, who have a desire to operate the business after Hank's retirement and who are currently important contributors to the ongoing business operations.
  - It would enable him to structure the transaction in a way that could provide a retirement income via dividends on preferred shares of the holding company from the freeze.
  - He could crystallize his available capital gains exemption. This effectively embeds the CGE amount selected into the adjusted cost base of his freeze shares, lowering the capital gain arising on the future disposition of the freeze shares.
  - It limits the amount of taxable income he would have to report at the time of his death, in respect of the freeze shares.

  Reference:
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 16.5.2*
  - *Estate Planning with Life Insurance, 7th Edition, 5.2*

- Since only two of Hank's children are involved in the operation of the business, he will need to consider how he will want to achieve estate equalization for LeeAnne, either with alternative estate assets and/or a newly acquired life insurance policy. Taxes at death will likewise have to be provided for.

  Reference:
  - *Estate Planning with Life Insurance, 7th Edition, 5.4 & 7.2(b)(iv)*

- Other responses may include an insured shareholder agreement or implementation of a systematic redemption strategy.

Question 2

Briefly explain to Hank four different ways that inter vivos trusts could be employed, now or in the near future, to help him to achieve his estate and financial planning objectives. Include, where appropriate, a short discussion of the income tax ramifications of setting up and operating the various trusts.

Solution

- Come age 65, Hank might want to consider setting up an alter ego trust and transferring at least some of his non-registered assets (particularly any preferred holding company shares arising from the freeze) to the trust. Hank could still be the income beneficiary for the trust (and its assets) but the assets would not form part of his estate at his death, thereby avoiding probate fees on hundreds of thousands of dollars of assets.

  ***Reference*:**
  - *Estate Planning with Life Insurance, 7th Edition, 3.3(c)(iv)*

- For Irene, he might want to consider setting up a Henson Trust, to provide her with support that would not interfere with her government benefits.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 12.3.1*

- Also, or alternatively, he might consider setting up an RDSP for Irene.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 12.3.1*

- Hank could consider setting up a charitable remainder trust for the benefit of the community association and settling preferred shares of the holding company from the estate freeze on the trust. He could still retain the income from the shares during his lifetime and could get a current charitable donation receipt for the discounted resent value of the gift that would pass to the charity at the time of his death. Note, however, his estate is reasonably modest and the cost of setting up a trust and redirecting the funds could preclude Hank from addressing other estate objectives in respect of his children and grandchildren.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 24.2.8*

Other responses may also include a joint partner trust for Hank and Marge and a family trust to hold the common shares as part of a freeze strategy.

Question 3

Outline four recommendations that you would put forward to Hank to help meet his will planning objectives.

Solution

- Obviously, Hank needs to update his will since his estate plan may involve an estate freeze that does not anticipate all three children. Depending on whether he purchases additional insurance, and how it is held, the asset distribution will need to be revisited.

  ***Reference*:**
  - *Estate Planning with Life Insurance, 7th Edition,7.2(b)(iv)*

- As well, once Hank marries Marge a new will is required, since marriage voids pre-existing wills in many jurisdictions in Canada.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 8.5.1.2.2*

- He would want to change the "per capita" distribution to "per stirpes", so that LeeAnne's children would not be disinherited if she were to predecease Hank.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 19.2.7*

- The will may require a hotchpot clause to take into consideration any reorganization planning with respect to the business assets that Brent and Karen may receive as a result of the estate freeze.

  ***Reference*:**
  - *Course Guide (257) 1.14*

- The will requires a new executor, and perhaps an alternate.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 20.1*

- Hank could consider setting up a testamentary spousal trust for Marge, to provide for her during her lifetime should Hank die first; however, this needs to be balanced with Brent and Karen's interest in the business, given that they are the primary resources carrying the business. The trust could also guarantee that the bulk of the estate would be left for his children when Marge dies but, again, this needs to be carefully balanced against Brent and Karen's interests during the lifetime of the new spouse.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 8.5.2.1*

- As part of the process of setting up the trust for Marge, Hank should look into initiating a prenuptial agreement with her, setting out her entitlements, so that any rights under provincial matrimonial property and dependents' relief legislation do not interfere with Hank's estate plan.

  ***Reference*:**
  - *Wealth Planning Strategies for Canadians, 2020 Edition, 17.2.5*

- He should be cautious about including a clause to disinherit Claude on religious grounds: this could be struck down as being against public policy.

  ***Reference*:**
  - Wealth *Planning* Strategies for Canadians, 2020 Edition, 10.5.9

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