Case Study: Business Estate Planning

Learning Objective:

- Understand and explain the planning needs and opportunities for owner-managers.
- Explain how estate plans are tailored to a business owner's situation.

The Facts

Fifty-eight-year-old Theresa is a widow and sole owner of an unincorporated business. She operates a consulting firm out of the house she owns that has been converted into an office complex solely for the purposes of housing her business. She has another house in Halifax in which she lives.

The business property was purchased for $240,000 and currently has a fair market value of $450,000 ($180,000 for the building and $270,000 for the land) and growing. The UCC for the building is currently $120,000.

Theresa hopes to retire no later than age 65, at which point she wants to turn the business over to the older two of her four children, aged 34 and 31, who currently work in the business with her.

Theresa has two younger adult children who have no affiliation with or interest in the business. The business has about $150,000 of equipment (ACB of $180,000 and UCC of $82,000) in addition to the building.

Neither Theresa nor any of her children has ever used any of their lifetime capital gains exemption (LCGE). The business generates a net (pre-tax) income of $800,000 a year, $300,000 of which is used by Theresa, with $150,000 being paid to each of the children who work in the business. The other $200,000 is taxed in Theresa’s hands as a sole proprietor, even though she does not require it to live on.

On the assumption that Theresa would no longer be involved in the business after retirement, it is estimated to be worth about $1,500,000, exclusive of its capital assets. Theresa expects her two eldest children to take over the business when she retires (she will have enough income/assets to live comfortably in retirement) and to carry it on after her retirement and eventual death.

The two children not involved in the business are both in university full-time and have annual incomes of less than $20,000 each. Theresa has come to you seeking advice on how to reduce taxes, now and at the time of her death, and how to best structure her estate to be fair to all of the children.

Question

Offer three recommendations, with possible income tax ramifications/advantages, that could help Theresa to achieve her objectives (you have already advised her that any suggestions with legal/tax implications should be referred to the appropriate expert advisors).

Reference

- *257 Advanced Estate Planning Study Guide (Study Unit 4)*
- *Wealth Planning Strategies for Canadians, 2019 Edition (Chapter 9 and 16)*
- *Estate Planning with Life Insurance, 6th Edition (Chapter 5)*

Solution

Theresa should consider incorporating her business. This would serve the dual purposes of:

- Qualifying the business interest for the LCGE; and,
- Allowing undistributed income ($200,000 a year at present) to be currently taxed in the business at about 15% (CCPC) rather than at about 50% in Theresa's hands (personally-owned), lowering current taxes by about $70,000 a year.

Once Theresa has set up a corporation in which she will operate the business, she could transfer the business (effectively goodwill), building and equipment into the corporation, on a tax-deferred rollover basis using section 85. That would, in effect, convert all accrued gains associated on these assets from a non-sheltered personal gain to a gain in the value of the corporate shares that would in turn be eligible for the LCGE.

Note that alternatively, Theresa could establish two corporations – one for the active business and one for the land and buildings. This could provide more flexibility for estate and succession planning.

When she retires, Theresa could consider implementing a corporate estate freeze. That would allow her to crystallize her LCGE and cap the unrealized capital gains at the time of the freeze. It would also allow the future growth in value of the corporation to accrue in the hands of her children (the beneficiaries of the freeze) and provide a multiplier effect in the use of their individual LCGEs.

Theresa could consider having the common shares held by an inter vivos family trust, rather than directly in the hands of the children active in the business. This would give Theresa more control than if the shares were held directly by the children, and also provide more flexibility when income splitting or in determining how much income to pay to those working in the business. They should also consider purchasing insurance in order to buyout Theresa or the two children (after they become shareholders) as time goes on.

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