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TAX

Effectively Structuring Your Company for Transition

Most people don't like change, especially when it comes to change that will have a lasting effect on their lives. For Mom and Dad, as owner-managers, one of the most significant changes is the transition of their business, which they have worked long and hard to develop and grow. Passing on the reigns of the business to someone else may be hard for them to imagine. However, not thinking ahead or planning for the future of the business could be costly, both from a business and tax perspective.

Little or no planning for a business transition could potentially result in about half of the value of the business being paid to the government in taxes. This would be very unfortunate, but it can be avoided. As all businesses will go through a transition, whether planned or not, and since no one can predict the future, giving some thought to the unexpected and to who might eventually take over the business can help.

There are many factors that will come into play when developing an optimal tax deferral/minimization strategy for a business transition. One of the main factors that will likely dictate the course of action to be taken is who the business will be transitioned to. There are really three main options for Mom and Dad to consider in thinking about the transition of their business: a sale or transfer to one or more of their family members, a sale or transfer to non-family management or a sale to an outside third party. Each option is considered in more detail below, and tax calculations for each assume that the applicable 2016 top marginal tax rate in Ontario applies.

A sale or transfer to family members is usually accomplished by way of an equity shift. This means that the incoming family members are acquiring shares of the business which will give them some or full control in the operation of the company and some or full participation in the future growth of the company. There are many ways to accomplish this. One of the more popular methods is to undertake a "freeze".

For example, assume Mom and Dad own all of the voting common shares of their Operating Company ("Opco") on a 50/50 basis. Opco has active business income and pays corporate tax at small business rates. Together, they paid $100 for the common shares when the company was set up. Today, the current fair market value of Opco is $5 million and the company is expected to continue to grow and increase in value. Their Daughter has been working in the business for several years and is ready to take over but does not have the $5 million needed to buy Mom and Dad's common shares directly from them.

If nothing is done to transfer control and value to Daughter during Mom and Dad's lifetime, then on the last to die there would be a deemed disposition at fair market value of the common shares of Opco. If the company's value at death is $5 million, this would result in a $5 million capital gain on the final personal tax return of the last to die, triggering taxes of approximately $1.34 million. It may be possible to claim the lifetime capital gains exemption (CGE) (which is $824,176 in 2016) if Opco was a qualified small business corporation (QSBC) at the time of death, however there are very specific criteria that Opco would have to meet, so it is possible that these would not be met.

If the estate has little or no cash, then the funds to pay the taxes will have to come from Opco. Getting funds from Opco into the estate would be done by way of dividends. However, this will trigger taxes in the estate on the dividends received from Opco. Assuming that all dividends would be ineligible, the estate would need to receive approximately $2.45 million of dividends, which would trigger another $1.11 million of tax. If the proper tax planning hasn't been done before and after Mom

and Dad's death, their estate could end up paying about half of the value of Opco in taxes. Although the common shares may have been left to Daughter in their Wills, Opco may not be able to continue as a result of the tax burden.

In order to facilitate Daughter acquiring shares in Opco for a nominal amount, Mom and Dad undertake a freeze of their common shares, exchanging them for fixed value preferred shares that are redeemable for $5 million. The fair market value of Opco is now "frozen" in the new preferred shares that Mom and Dad received in exchange for their common shares. This essentially locks in the value for Mom and Dad, helping to plan for their future tax liability. Daughter can then acquire voting common shares in Opco for a nominal amount. This would give her control and allow her to participate in the future growth of Opco. In order to protect their nest egg, Mom and Dad may want to retain some level of control in Opco. With additional planning, this can be achieved as part of the freeze transaction.

The $5 million of preferred shares can provide cash flow to Mom and Dad in retirement by having the company redeem some of those shares each year. The redemptions will result in dividend income to Mom and Dad. However, if they are able to manage their personal cash needs each year for both to stay under the top marginal tax bracket the redemptions over time could reduce their overall tax burden. At a minimum, if Mom and Dad had no other income they could each receive ineligible dividends of approximately $33,000 each year and they would not pay any personal tax. This planning does not allow Mom and Dad to claim the CGE, so this may be something they want to consider before freezing their shares.

A second option for the transition of the business is a sale or transfer to non-family management. This could also be accomplished by way of an equity shift. However, depending on the relationship between Mom and Dad and the management buyers, Mom and Dad may just want to cash out.

There are many options to structure a tax-efficient transition in this scenario. If the management buyers do not have the $5 million needed to buy Mom and Dad's common shares directly from them, they could consider undertaking a leveraged recapitalization. This would involve Opco obtaining third party financing and then using the funds to repurchase Mom and Dad's shares. Immediately after Mom and Dad's shares are repurchased, the management buyers could then subscribe for new common shares for a nominal amount. The $5 million that Mom and Dad receive from Opco would be considered a dividend, which would trigger approximately $2.3 million of tax.

They could also consider a partial leveraged recapitalization, where only a portion of Mom and Dad's shares are repurchased by Opco and then the management buyers would purchase any remaining Opco common shares held by Mom and Dad. If Opco is a QSBC, then Mom and Dad may each be able to use their lifetime CGE on the sale of the remaining common shares, so they may want to structure the buyout with this in mind. If $1.64 million worth of common shares were to be purchased by the management buyers, this could save Mom and Dad approximately $745,000 in taxes compared with the full leveraged recapitalization.

The third option is a sale to an outside third party. Mom and Dad would likely just want to cash out but there could be a period of time where they may be required to retain some ownership in Opco. There are three main ways to structure a third party sale: Mom and Dad could sell their shares of Opco to prospective buyers, Opco could sell all of the business assets to prospective buyers, or a combination of the two (referred to here as a "hybrid" sale).

Mom and Dad may prefer to sell the shares of Opco if it is a QSBC as they could shelter approximately $1.64 million of capital gains from tax, which would save them approximately $441,000 in tax. However, the prospective buyers may prefer to purchase the assets of the business from Opco. Depending on the fair market values and cost amounts of the assets in Opco, a sale of assets could result in significant taxable income in Opco. The only way for Mom and Dad to get funds out of Opco after the assets are sold is by way of dividends, where they would have no ability to take advantage of the CGE.

Lastly, it may be possible to negotiate a hybrid sale, which would involve a few more steps. First, some assets in Opco would be sold, following which the after-tax sale proceeds in Opco would be paid to Mom and Dad as a dividend. Then they would sell their shares of Opco for a lower amount, triggering capital gains that might be sheltered by the CGE.

Once it has been determined who the business will be transitioned to, and a high level course of action is decided upon, there are many other things that should be considered as part of the overall tax deferral/minimization plan, including:

- Are there other family members (i.e. children, grandchildren) that have not yet claimed their lifetime CGE? If that's the case, a structure could be put in place well in advance of a share sale that would allow other family members to claim their CGE to shelter more of the capital gain from tax.
- Do the current shareholders need the cash now for personal use? If they don't and the transition plan involves share redemptions, repurchases or dividends, consideration could be given to putting a holding company in place that could receive the dividends tax-free.
- Would life insurance be a useful way to provide the funds necessary to pay the taxes on the last to die of Mom and Dad?
- Are there tax attributes at play that should be used? For example, does the company have a capital dividend account balance from which it could pay tax-free capital dividends to the shareholders?

Whether we like it or not, change is inevitable. As a business owner, not thinking ahead and planning for change could result in paying more tax than necessary. As discussed above, there are many variables to consider in determining an optimal transition plan that will defer/minimize tax, so it is very important to plan ahead.

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