



PRIVATE CLIENT ADVISORY SERVICES

Succession Planning for Small and Medium Sized Enterprises

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Our Objective Today



To inform you of tax planning techniques for Family Business Succession





1. Succession planning overview
2. Succession tax planning
3. Example of “estate freeze



1. Succession planning overview



- **Process of transitioning the management and the ownership of the business to the next generation of family members**



- Over the next 20 years \$15 trillion in wealth will be transferred between generations....

CAFE: Most family businesses are not ready!



- 70% do not survive transition to the second generation
- 90% do not survive to third generation
- 95% do not have a succession plan

Succession Failure: Top five reasons



- Procrastination
- Wishful thinking
- Saving on advice
- Confusing equality with fairness
- Failure to share philosophies/vision



- **Successful transitions happen when they are thoughtfully planned**
- **Planning involves change**
- **Change means risk and potential for conflict**



- Above all....Start Early!
- Do not wait until owner is ready to retire
- Three to five years usually needed to:
 - Build successors' skills
 - Gain stakeholders' confidence

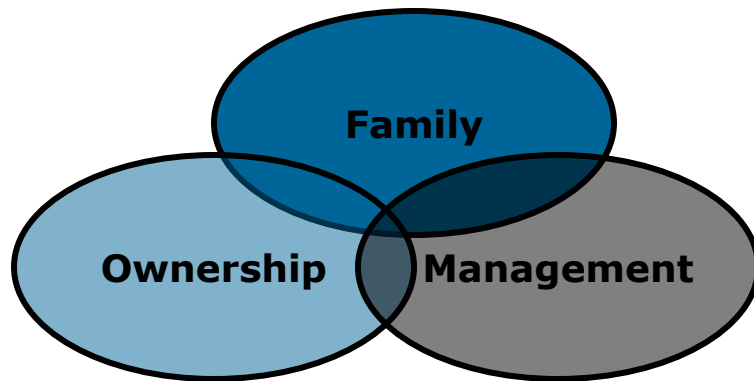


Too often, the process focuses on **economics** without consideration for the **people** behind the **economics**.

The Family Business System



- Three circles below illustrates the interaction/impact of the family component on management and ownership of family business.



- Differences of opinion are structural
- Position impacts perspective on policies
- Boundaries are often unclear
- Conflict is inevitable



■ Equity Matters

- Successor can provide that freeze shares are divided equally on death and entitled to reasonable dividends
 - Common shares held by active member

■ Compensation Matters

- Active members must be compensated reasonably
 - May need third party involvement in valuation
 - Consider year-end bonuses on profits



2. Succession tax planning



- **Tax efficient transfer of the business to the next generation**
 - Without giving up control
 - Allowing future flexibility



- Undertake freeze of owner's existing value in company
- All future growth to accrue to children
- Owner retains voting control during lifetime



- Involves capping owner's interest by issuing preferred shares that have a "fixed" value equal to current Fair Market Value (FMV)
- Variety of methods
- Depends upon objectives of freezor and tax considerations
- Capital gain could be triggered to utilize Qualified Small Business Corporation ("QSBC") exemption



- Taxable transaction (sale or gift)
- Internal Freeze – Share Exchange
- Transfer of Shares
 - Transfer to Holdco
 - Internal transfer to same corporation



- Useful when final outcome not yet known
 - Provides flexibility where no clear successor
 - Freezor could be a beneficiary to allow unwind
 - May allow income splitting (watch kiddie tax)
 - Multiplication of capital gains exemption
 - Creditor protection
 - 21 year “shelf life”

- Involved in decisions by being a trustee



3. How does the lifetime capital gains exemption work?

Can it be shared with my spouse and/or children?

Maximizing Capital Gain Exemption



- Federal Budget increase to \$800,000
- Available on sale of
 - Shares of QSBC
 - Qualified Farm Property
 - Qualified Fishing Property
- Use of family trusts to allow access to Capital Gain Exemption (“CGE”) of family members
- Crystallization of CGE while the shares qualify



- In order for a company to be a small business corporation, it must meet the following criteria:
 - A Canadian Controlled Private Corporation (“CCPC”)
 - 50% of the FMV of the assets must be used in active business in Canada during the 24 month period prior to sale
 - 90% of the FMV of assets used in active business in Canada at time of sale
 - The shares must be held by the taxpayer or a related person/partnership for 24 months immediately preceding the sale (requirement waived for newly incorporated partnerships or proprietorships)

Qualifying Small Business Corporation



- **Methods of purification include:**
 - Use non-business assets to pay off liabilities
 - Pay shareholder loans with excess cash
 - Pay capital dividends with excess cash
 - Invest in business assets or other QSBCs

- Due to the 24-month holding test, care must be taken in executing tax planning arrangements to ensure ownership is not transferred to an unrelated person/partnership

Can CGE be multiplied with my spouse and/or children?



- The CGE can be multiplied with spouses and children when appropriate tax planning arrangements have been implemented
- Care should be taken in executing transactions before the sale of the business, as tax-free inter-corporate dividends can be taxed as capital gains



■ Example – Facts

- Mr. A is 60 years old and has not utilized his CGE
- Mr. A has 3 children who have never utilized their CGE
- FMV of OPCO = \$2,000,000
- Mr. A is considering selling the business within 2/3 years

Mr. A

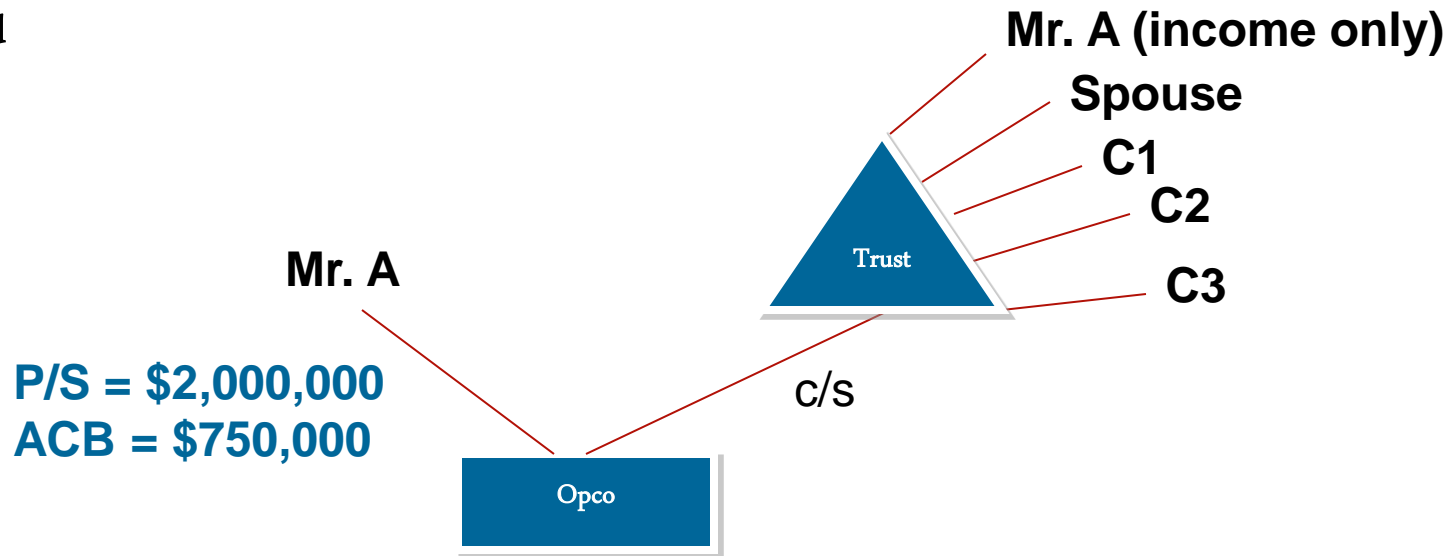
ACB = \$1

FMV = \$2,000,000

Opco



■ Proposed



- Able to maximize CGE and also avoid 2 year holding period
- Mr. A reorganizes and takes back preferred shares (preferred shares valued at \$2,000,000 and common shares of OPCO)
- Mr. A sells the common shares to Trust for FMV
- The Tax Act contains provisions to allow for exemption from 24 month holding period



4. Example of Estate Freeze

Example of estate freeze



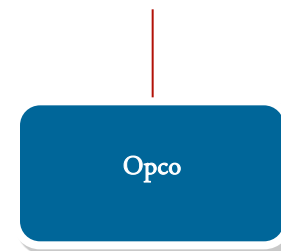
Mr. Marcus

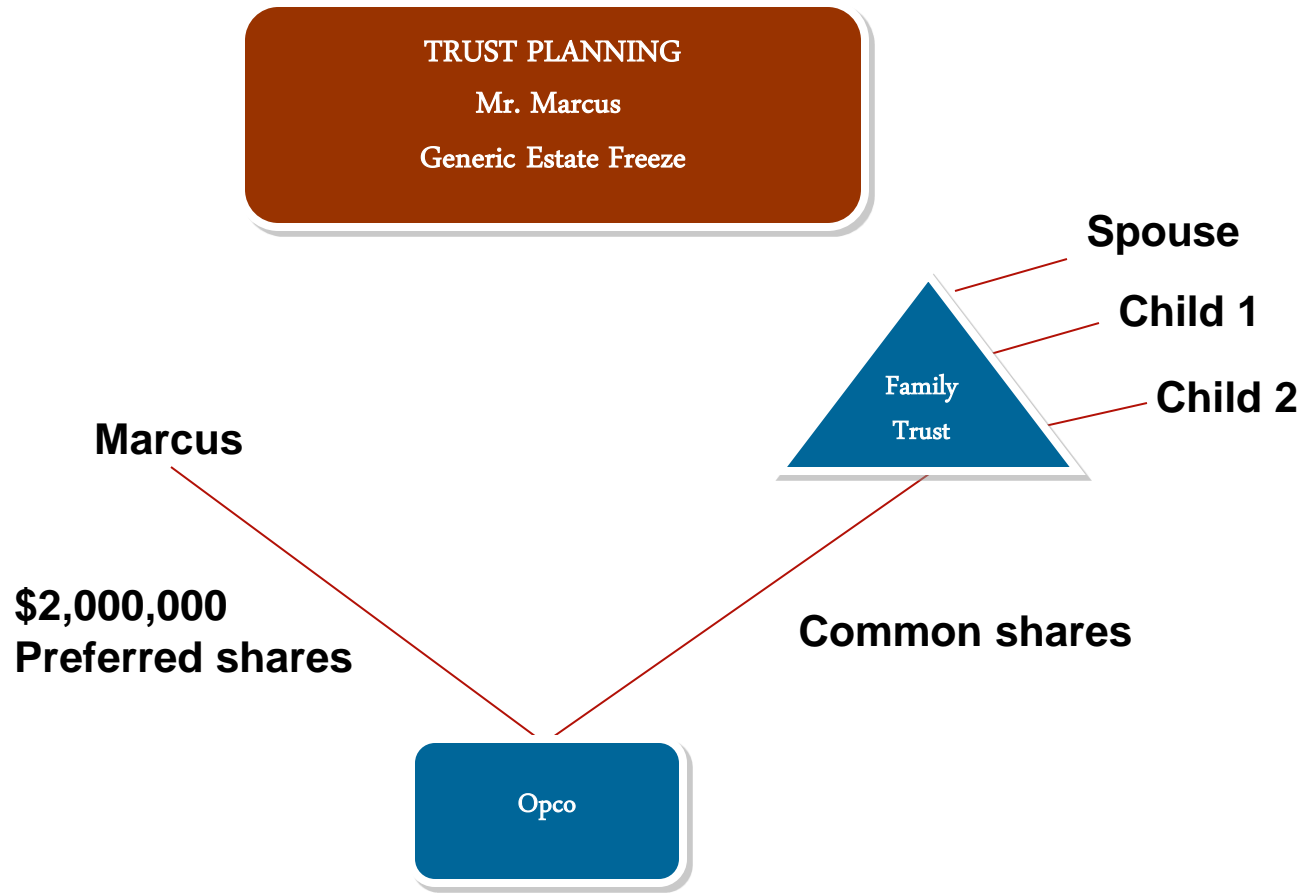
- 67 years old, single
- Shares of Opco – Value \$2,000,000
- Mr. Marcus is married
- Marcus has 2 adult children active in business
- Marcus has grandchildren

Considerations

- Estate tax
- Probate fees
- Income splitting
- Capital gains exemption
- Power of Attorney
- Asset protection

Marcus





Summary



- Start early
- Treat management and ownership separately
- What is the plan/exit strategy
- Consider tax consequences , but...
- Don't forget the family component
- Be open
- Get help



- Family Business Organizations
 - CAFE
 - CFIB
- Business Advisors
 - Accountant
 - Lawyer
 - Investment advisor
 - Insurance advisor
- Reading on the web
- Books



Questions?