Tax + Estate Business Owners Kit

Part 4 Succession and Estate Planning

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Estate planning is important for everyone.

A well-executed plan could minimize tax payable at death, reduce conflict amongst beneficiaries, and maximize assets available to heirs.

Part 4 of the Tax & Estate Planning for Incorporated Business Owners series discusses succession and estate planning.

Incorporated business owners can face difficult tax and estate planning decisions involving their shares. In the absence of a tax-deferred rollover of qualified property such as shares of an incorporated business, all capital property including private company shares are deemed sold at fair market value (FMV) immediately before the shareholder's death, which typically results in a significant tax bill. Since many businesses are built from the ground up with little to no investment capital, businesses can have high FMVs but low adjusted cost base (ACB) resulting in high taxable capital gains. This often translates into a significant tax liability for the deceased's estate, which can force the sale of the company should other assets not be available to cover the tax bill.

Incorporated business owners may wish to consider the estate planning strategies discussed in this series for optimal succession and tax minimization.

This is Part 4 of the Tax and estate planning for incorporated business owners series

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An estate plan includes strategies for funding an individual's lifestyle in retirement, transferring private company ownership and wealth protection.

What is an estate plan?

An estate plan is a comprehensive analysis of the current and prospective affairs of an individual. This includes creating tax-efficient strategies for generating, managing and distributing wealth.

More specifically, an estate plan includes strategies for funding an individual's lifestyle in retirement, transferring private company ownership and wealth protection.

Incorporated business owners at some point will need to decide who will take over the business. This could be a transfer or sale to a family member, partner, key employee, or third party. Some incorporated business owners will require the sale proceeds in order to fund their retirement lifestyle, while others may not. Whether selling to an unrelated or related party, tax-efficient strategies should be considered before a sale or transfer of the shares.

As a final thought, business owners should also have plans to facilitate the transfer of shares of their businesses in the event that they pass away. This will be covered in Part 5 of the Incorporated Business Owners kit.

For incorporated business owners looking to exit the business, the following options can be considered:

1. **Sale or gift of shares**
2. **Discontinue the company**
3. **Estate freeze**

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Sale or gift of shares

Generally, those connected by blood, marriage or adoption are considered related persons. In some cases, unrelated parties may be deemed to be related if they are acting in concert. Either way, it's best to consult an accountant who can make the distinction and help structure the transaction tax-efficiently.

Incorporated business owners who want to exit the business and require the proceeds from the sale to fund their lifestyle will likely sell their shares to an unrelated party or a related family member for FMV proceeds. The Lifetime Capital Gains Exemption (LCGE) may be available to reduce the tax impact.

When selling private company shares to a related family member, the disposition occurs at FMV, regardless of what price is agreed to between the parties. The purchasers ACB is not deemed to be FMV (unless FMV is charged or the property was gifted); it's what they paid. Charging an amount above or below FMV can lead to double taxation when looking at the parties' tax position in aggregate (see example below).

If the intent is to gift shares to a related family member, then no consideration can be charged or accepted in exchange on the transfer, otherwise the parties can be exposed to a double tax. In this case, the deemed ACB for the family member receiving the gift will equal the FMV proceeds taxed to the seller, and not the actual price paid (Nil in this case).

Example:

Fabio wants to sell his private company shares (ACB $100) to his brother Enzo and is willing to accept an amount below FMV. The shares are currently worth $10,000, Fabio does not require the proceeds but is not aware of the tax implications if he gifts versus selling at a discounted price.

Fabio's tax implications

	Gift	Sell for $1
Deemed proceeds	10,000	10,000
ACB	100	100
Capital Gain	9,900	9,900
Taxable Capital Gain	4,950	4,950
Tax 53.53%	2,650	2,650

Fabio's deemed proceeds and income tax implications will be the same regardless if he gifts or accepts consideration below FMV. However, Fabio should ensure he has the available cash flow to cover the tax liability regardless if he gifts or sells at a discount.

Enzo on the other hand will inherit an ACB equal to the FMV, provided his brother gifts him the shares. However, if Fabio charges Enzo, even $1, Enzo's ACB becomes what he actually paid. This unfortunately taxes Enzo on the same capital gain exposed to Fabio, resulting in double taxation (see below).

The following is an ACB/tax comparison if Enzo received a gift of shares versus paying $1 on the transfer.

Enzo's income tax implications when he sells assuming no share appreciation and rate change.

	Gift	Sell for $1
Proceeds	10,000	10,000
ACB	10,000	1
Capital Gain	–	9,999
Taxable Capital Gain	–	5,000
Tax	–	2,676

When selling to related parties, it's important to either gift the property or charge FMV. This will ensure the related family members ACB equals FMV, since a price charged above or below exposes the parties to a double tax.

To complicate matters, there may be further tax implications if the LCGE was claimed on the sale to a related family member. For instance, the portion sheltered, could result in dividend taxation when undergoing certain corporate restructuring. Speaking with a qualified tax practitioner can help execute a tax-efficient plan.

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Discontinue the company

Another option available for incorporated business owners if the LCGE is not available or if the shares cannot be sold (i.e. no operating business), is to liquidate the underlying corporate assets and wind up the company. This usually involves paying tax when corporate assets with appreciated gains are sold. When the underlying net corporate proceeds (cash or other properties) are distributed, the individual shareholder will receive a dividend equal to the net value of the company in excess of paid up capital. The excess amount can be significant and could be taxed at top rates. For this reason, it may be better to undergo an estate freeze which can help defer and manage the tax bill.

Example:

Rocco wants to sell his company which holds a piece of equipment (assume no tax depreciation) used exclusively in his active business (no further assets or liabilities). The equipment is currently worth $10M and has an ACB of $5M.

Rocco incorporated his company years ago for a nominal amount. From a tax perspective, he is not sure whether to sell the asset directly and proceed to wind up or sell the shares assuming they qualify for the LCGE.

Asset sale		
Proceeds	10,000,000	
Adjusted cost base	(5,000,000)	
Capital gain	5,000,000	
Taxable capital gain	2,500,000	
Corporate tax	(1,254,250)	
Refundable tax	766,750	
Net corporate tax		(487,500)
Tax free dividend payment	(2,500,000)	
Excess proceeds distributed as taxable non-eligible dividend	7,012,500	
Tax on non-eligible dividend		(3,347,768)
Combined after tax proceeds		**6,164,732**

Share sale	
Proceeds[1]	8,745,750
Adjusted cost base	(100)
Capital gain	8,745,650
LCGE	(892,218)
Net capital gain	7,853,432
Taxable capital gain	3,926,716
Personal tax	2,101,971
After tax proceeds	**6,643,779**

1. The share value is discounted for corporate tax.

Assumptions: 2021 Ontario Tax Rates. Corporate Tax: 50.17%. RDTOH: 30.67%. Non-eligible dividends: 47.74%

For a summary of potential advantages and disadvantages of a share versus assets sale please refer to appendix A.

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Capital gains reserve

The capital gains reserve allows a taxpayer to spread the realized capital gain over a period of more than one year, provided the proceeds are also received over the same time. Whether the shares are sold to a related or unrelated party the capital gains reserve may allow a tax reduction and/or deferral. The maximum period over which the reserve may be claimed is usually 5 years, or 10 years, for qualified farm/fishing property. Structuring the transaction so the capital gains reserve is available should be discussed with your accountant before entering into a purchase and sale agreement.

Example:

Rocco realizes a taxable capital gain of $500,000 on the sale of his company shares in 2021. Assuming this is his only income he will be required to pay $228,909 of tax in Ontario. If the transaction is structured to allow the proceeds to evenly be received over a 5-year period, this can access lower graduated rates and defer tax. In year 1, his effective tax rate reduces from 45.78% to 23.45%. Assuming the rates remain consistent, he can defer $93,820. In aggregate, assuming the rate is consistent over the 5-year period, his overall tax liability has been reduced to $117,275 saving roughly $111,634 in tax.

Estate freeze

First, you need to consider the company's successor/s and how you will be compensated. In a traditional estate freeze you will exchange your common shares for fixed value preferred shares equal to the FMV of the company at that time. The current value of the company is now held by the preferred shareholder, allowing the new common shareholder/s (usually a family member or family trust) to subscribe for common shares at a nominal amount. The future value of the company will therefore accrue to the future generation (the new common shareholders). One of the other advantages of implementing an estate freeze is to provide some certainty with regard to a business owner's eventual tax liability at death, which allows for advanced planning to fund the liability. Also, it can provide a steady cash flow over numerous years provided the shares are gradually redeemed.

Usually preferred shares do not participate in the future profits of the company, so the retired shareholder will redeem their preferred shares over time allowing a steady dividend income stream, allowing for a possible tax deferral and/or reduction over numerous years.

The new growth shares (common shares) in a generational transfer are usually owned by a related family member directly or indirectly as a beneficiary through a family trust (inter vivos trust discussed below). When paying a dividend to the related family member shareholders or allocating income received from the company to beneficiaries of a family trust, it's important to consider the new income sprinkling rules as top rate taxation could apply if an exception under the new rules is not met.

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Here are some additional points to consider:

- Each beneficiary of a family trust can utilize their LCGE when the shares are sold
- Dividends paid to minor beneficiaries will be taxed at top rates
- Dividends allocated to adult beneficiaries must consider the new income sprinkling rules (discussed below)
- The shares held in the trust bypass any deceased estates i.e., probate tax savings
- Incorporated business owners undergoing any corporate reorganization should look to update wills accordingly

Example:

Rocco is sole shareholder of a successful company. Currently, Rocco is looking to exit the business and his children intend to take over. The shares are worth $1M which will provide the funds required for Rocco's retirement.

In speaking with his financial advisor, Rocco was informed that he could "freeze" the value of his company shares while future growth and the associated tax liability accrues to his adult children. Doing so would allow Rocco to estimate (and plan for) his potential tax liability at death while gifting the future growth of the company to his children with little upfront investment.

Rocco exchanged his common shares for $1M fixed value preferred shares redeemable for $1 per share. The value of the exchange must equal the value of the company at that time. Now that the current value is held by Rocco in the form of preferred shares, Rocco's children can subscribe directly for common growth shares for a nominal amount or indirectly through a family trust.

The $1M preferred shares, allows Rocco to estimate and plan for his total tax liability for his shareholdings. In the meantime, he can redeem the shares, which not only reduce his current holdings, but also provides a steady income flow and spreads the tax liability over his remaining years. The remaining unredeemed preferred shares held on his death will be deemed disposed of for FMV.

Once the freeze is implemented, Rocco would proceed to update his will for the change in ownership.

One of the advantages of implementing an estate freeze is to provide some certainty with regard to a business owner's eventual tax liability at death, which allows for advanced planning to fund the liability.

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Inter vivos trusts

An inter vivos trust is a formal trust established during the lifetime of its settlor. As previously discussed, an inter vivos trust such as a family trust can be an effective estate planning tool for incorporated business owners undergoing an estate freeze. It can also reduce conflict amongst beneficiaries because the incorporated business owner's intentions will have been made clear in advance of death.

Generally, a disposition at FMV will occur when assets are transferred to an inter vivos trust. In some cases, a tax deferral may be available, as is the case with a traditional estate freeze (previously discussed) or the use of certain trusts such as alter ego and joint partner.

Probate and privacy

Assets held in an inter vivos trust bypass the estate of a deceased settlor, thereby reducing estate administration fees. Also, they help mitigate complex estate settlements by minimizing the risk of litigation as wills can be challenged. Trusts offer privacy and confidentiality since probated wills can be accessed by the public whereas trust agreements remain private.

Taxation

Unlike individuals, who are taxed at graduated rates, every dollar earned in an inter vivos trust is taxed at the top rates in the province/territory of residence. For this reason, income earned in an inter vivos trust is often distributed or made payable to beneficiaries of the trust and taxed in their hands personally. Where the trust receives a dividend as shareholder of a corporation, the dividend can be allocated and taxed to the beneficiary at lower rates, provided an exception is met under the new income sprinkling rules. As is the case with formal trusts, annual tax filings would be required.

For more information on inter vivos trusts, see Mackenzie's "Strategies for Trusts in Tax and Estate Planning" brochure (TE1018).

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Wills

Testamentary freedom generally allows individuals to dispose of their assets as they see fit. The expression of this freedom is found in the will. The will provides for the appointment of an executor or liquidator and the ultimate distribution and general administration of the testator's or will-maker's estate. On the contrary, if an individual died without a will, known as intestacy, testamentary freedom is ceded to provincial and territorial governments applying predetermined legislative rules for the distribution of an "intestate" estate.

The will may also provide for guardians for minor children, bequests to charity and testamentary trusts.

Probate

Provincial/Territorial legislation may require probate of a will before registering real estate or transferring certain assets to the executor. The probate process comes at a cost. For example, in Ontario, it is 1.5% of the gross value of the estate in excess of $50,000 and 1.4% in BC. Please refer to Mackenzie's "Estate Planning and Quick Reference Guide" for all provincial/ territorial probate rates.

Dual wills

Some testators would like to minimize the cost of probate by deploying a multiple or dual wills strategy. This is true particularly for incorporated business owners.

As noted in the introduction to this module, because many incorporated businesses are built from the ground up with little to no investment capital, business can have high values and low adjusted cost base when death occurs. As a result, the probate cost for private company shares could potentially be astronomical.

While it is legally questionable whether this strategy is applicable throughout Canada, it has been held to be applicable in Ontario and British Columbia.

A dual will strategy separates probatable and non- probateble assets helping to mitigate high probate fees. The primary will deals with assets that must be probated. The secondary will deals will non-probatable assets such as private company shares.

When using this strategy, beneficiaries may not require probate for receipt of the private company shares, resulting in significant probate tax savings.

While it is legally questionable whether this strategy is applicable throughout Canada, it has been held to be applicable in Ontario and British Columbia.

Finally, since probated wills become publicly accessible, the contents of the secondary will remains private, and for some, this may be another reason for adopting this strategy.

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Powers of attorney

Uncertainty can arise when an incorporated business owner loses the mental capacity to make business decisions. To avoid this situation, the drafting of a power of attorney (POA), or a Mandate should be considered.

A POA is often the simplest and most cost-effective way to appoint an alternate decision-maker should an individual become incapacitated. Where the POA is "enduring" or "continuing", would usually remain effective in the case of mental incapacity. Depending on the terms of the POA document, the attorney, perhaps a spouse, adult child, accountant, lawyer, trust company, or a combination, could be granted the authority to act immediately or on the occurrence of a particular event (e.g. mental incapacity). Specific timelines can also be defined, if, for example, a business owner needs to be away for a period of time. POAs can be critical to a business, particularly where time-sensitive decisions need to be made.

Often, decisions that need to be made with respect to an incorporated business owner's personal matters are significantly different from those that need to be made for a company. Where this is the case, two separate POAs can be established. One POA could appoint one or more decision-makers for business matters, while a second POA could appoint decision-makers for personal matters.

If an incorporated business owner becomes mentally incapacitated without having prepared an enduring POA, a substitute decision-maker may need to apply to the courts for appointment. In addition to being significantly more costly than the preparation of a POA, a court appointment can take time to obtain. In the absence of another shareholder of the company or co-director, the business may be left without direction during this period. Also, should the person appointed by the court not be the person the owner would have chosen – particularly if the appointed individual has no experience with the business – complications can arise.

POAs are prepared with the assistance of a lawyer and, along with wills, should be reviewed on a triennial basis.

In addition to your Power of Attorney for your personal property, consider drafting a second Power of Attorney to deal with your business.

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Shareholder agreements

Shareholders agreements are legal documents used when there are multiple shareholders of a company. The premise is to ensure shareholder relationships are maintained, rights are protected, and the corporation continues to operate should disputes, divorce, or unexpected death or disability arise. To avoid possible disagreements or ensuring the company continues without interruption, owners can agree to fair terms in advance.

A POA is often the simplest and most cost-effective way to appoint an alternate decision-maker should an individual become incapacitated.

For example, in the event of a shareholder's death, it can be written in the agreement, whether family members can become shareholders or if the company is required to redeem shares held by the estate. Beneficiaries may prefer to access their inheritance outright rather than having it tied up in a company controlled by a sibling, parent or other party. A corporate owned life insurance policy can assure access to the funds are available for either a direct share purchase or share redemption (discussed below).

In the event of death or loss of mental capacity, the shareholders agreement can address a process to hire or appoint a successor so there is little to no business interruption.

Life insurance

For many incorporated business owners, life insurance can be an effective strategy for managing estate taxes. Besides having to liquidate corporate assets or sell/ discontinue the company entirely, the death benefit can be received tax-free, whether owned personally or by the corporation. Usually, the proceeds of a corporate-owned exempt policy in excess of the policy's ACB is credited to the capital dividend account immediately following the death of the incorporated business owner. The proceeds can be used to redeem shares held by disinterested beneficiaries or pay the tax liability.

Alternatively, where children are divided in their interest to continue a business after the incorporated business owner's death, life insurance can be used to provide equal inheritances to the children without having to sell business assets or company shares. The company can be left to the children who are interested in continuing the business, with the proceeds of the policy paid to those who are not.

Life insurance can ensure money is available to business partners, existing shareholders, or the company to allow the buyout of an inheritor's interest. This can help facilitate the objectives of all parties.

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Testamentary trusts

Whether or not a business is incorporated, the use of one or more testamentary trusts can be advantageous. Testamentary trusts are created at death typically by way of the deceased's will, but can also be created through a beneficiary designation on a registered plan application or life insurance contract.

Individuals typically have the choice to gift their assets during life (inter vivos) or at death (testamentary).

At the time of death, gifts could be made directly to estate beneficiaries, or indirectly through a testamentary trust created by the will.

Testamentary trusts are formal trusts which require annual compliance and other costs but can protect the beneficiaries from accessing funds or liquidating assets. Generally, testamentary trusts are taxed at the top tax rate of the province/territory of residence. There are two exceptions, namely Graduated Rate Estates (GRE) and Qualified Disability Trusts (QDT). Both of these testamentary trusts are taxed at graduated tax rates subject to meeting certain criteria.

In situations where the beneficiaries are for example, minors or spendthrifts, testamentary trusts can be used to control the timing of the inheritances, and also allow for better management of the funds. They may also be useful in other situations as well, such as for children with disabilities, individuals in second marriages, wealth management, and asset protection from creditors/themselves.

For incorporated business owners there are various considerations to be addressed before gifting the shares by will. For instance, if there is a surviving spouse or common law partner (CLP), the shares could be transferred tax deferred, directly or indirectly through a spousal testamentary trust, provided certain criteria is met. However, where there is no surviving spouse/CLP, a decision whether the business will continue after the incorporated business owner's death and who is best to succeed the business should be addressed during life. However, using a testamentary trust could limit the estate's ability to use certain post-mortem tax planning strategies, where double taxation can be an issue. This topic is covered further in Part 5 of the Incorporated Business Owners Kit.

For more information on testamentary trusts, see Mackenzie's "Strategies for Trusts in Tax and Estate Planning" brochure (TE1018).

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Leaving a legacy

Often, an incorporated business owner decides to leave the residue of their estate, including their private company shares, to a registered charity.

Certain registered charities may not accept shares of a private company, in which case, a private foundation, although costly, can be used, offering valuable tax benefits. Provided the incorporated business owners estate is considered a graduated rate estate (GRE), there is more flexibility in terms of claiming the donation tax credit to offset taxes owing. The donation tax credit could be applied in the year of death, the year prior to death, any year the estate is considered a GRE, or carried forward five additional tax years.

Assessing the options

For many incorporated business owners, estate planning is just as important as the accumulation of assets in a business and the deployment of those assets in retirement. This is particularly true where business owners wish to provide for family members after death, or ensure the continuation of a business beyond death. Because of the many options available in defining an effective estate plan, it is a good idea to work with a team of professional advisors (i.e. financial advisor, accountant and lawyer) to determine the options best suited to a particular owner and business. This can allow them to see the potential tax, financial, and business implications that often follow a death, but it would also encourage a review of family dynamics, which can help prevent conflicts in the future.

Note: Estate donations made between 36-60 months after death can still benefit from a donation tax credit in some circumstances.

Business owners devote a significant amount of time and money to their business over the course of their life. Creating a clear estate planning roadmap allows you to maximize the value of your business and transition it smoothly to your loved ones in a strategic and tax efficient manner.

Part 5 of the Business Owner kit continues along this path to focus specifically on the tax issues that shareholders of private corporations are exposed to at the time of death. If your estate plan involves transitioning your business interests only after your death or if you pass away prior to transitioning your business, you may wish to also consider the strategies discussed in Part 5 as part of your estate plan. It discusses strategies to reduce the potential tax liability at death and is a great complement to this series.

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Appendix A

Summary of potential advantages and disadvantages of share vs. asset sale

Share sale	
Advantage	**Disadvantage**
Seller	
Potential use of the LCGE	Sale price may be discounted
Lower capital gain rates apply	
Potential use of the capital gain reserve to defer and/or reduce tax	
Less reporting compliance	
Purchaser	
Potential access to non-capital losses or other balances	May need to purchase unrequired assets
Bypass land transfer tax if real property held in the company	Potential risk of undisclosed liabilities
No HST on purchase	

Asset sale and discontinue the company	
Advantage	**Disadvantage**
Seller	
Dispose of assets no longer required	Dividend rates apply-potentially higher tax if company winds up
	Heavy reporting compliance when company proceeds to wind up
	May not be able to dispose of all assets to one purchaser
	Cannot access the LCGE on sale of assets
	GST/HST could apply on the sale of certain properties – this can be a burden to both parties
Purchaser	
Can purchase desired assets	Land transfer taxes could apply on purchase of real property
No risk of inherent liabilities	GST/HST could apply on the sale of certain properties – this can be a burden to both parties
Potential increase in cost base-ACB equals price paid	

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