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Succession Planning for Family Businesses

The numbers are surprising – studies have shown that only one third of family-owned businesses survive the transition to the second generation. And of these businesses, again only one-third will survive to the third generation, meaning that the chances your grandchildren will take over your business are about 1 in 10.

Also interesting is the fact that studies across Canada and the U.S. have shown that more than three-fourths of current family businesses will have to deal with leadership changes in the next 10 to 15 years. Is your business one of them? Have you thought about the impact of this possibility on you, your family and your business? Better yet, have you begun taking steps to plan for it?

Succession, especially in a family business, is a process rather than an event. So, the sooner you start the process, the better your chances of success. In many cases, business owners give thought to a succession plan, but they put off implementation. This can cause serious problems if you leave the business earlier than planned due to death or illness. Your successor will be making his or her first key business decisions during a difficult time and the health of the business could suffer.

General comments about family businesses

As a business owner, chances are you've worked hard to build your business and you want your business to continue to thrive after you retire, whether your children succeed you or you sell your business to others. As well, chances are your business is your biggest asset, so doing all you can to maximize the value of it when you do exit from it is vitally important to your financial future.

Planning to ensure your family business' success

As a family business owner you are probably quite busy. Indeed, at times you may feel there are barely enough hours in the day to keep up with day-to-day pressures of family and business, and long-term planning can seem like a luxury you just don't have time for. But, as an experienced businessperson, you also know that without proper planning, businesses (and families) don't flourish.

This bulletin is intended to help you start thinking more about a number of issues you should consider to plan for your financial future and for your business' future. The first half of this bulletin focuses mainly on succession planning for your business, as well as some business planning strategies you should consider. The second half of this bulletin focuses on retirement planning in general, estate planning and the need to coordinate these plans with your succession plan.

As you go through this bulletin with a view toward creating your own succession plan and estate plan, remember that your BDO advisor is ready to help you at every stage.

Why families don't retain their businesses

As noted earlier, a surprisingly small number of family-owned businesses survive transition to the second generation. There are two common reasons why families don't retain their businesses. The first reason is straightforward: there is no qualified successor. However, even if your business will not be passed down to the next generation, making sure you take steps to ensure the value of your business survives is just as important and is really just another form of succession planning.

The second major reason for unsuccessful business transitions is more unfortunate. In many cases, family businesses fail or are sold off because of a lack of planning. Though most of us are careful to safeguard our personal assets, for example, insuring our homes, many businesspeople do not plan ahead to safeguard the value of their business.

At first glance, this lack of planning seems incomprehensible. But, when you look at the personal and family issues involved, it is easy to understand why many people just don't want to deal with the issue of business succession.

For most business owners, their business is their single largest asset in terms of value. But, beyond that, their business also represents a major source of self-esteem and personal worth. In short – for many business owners, their identity is very much wrapped up in their business. So, thinking about how they might exit the business means they must come to grips with personal identity issues. Consequently, many just don't want to think about the day when they retire and are no longer running the business.

In addition to the fear of retirement, the business succession process must invariably deal with the business owner's death. Surveys showing how few of us have prepared a will are clear evidence that death is difficult for most to contemplate.

Finally, for those individuals making it past the first two succession planning hurdles (contemplating retirement and death), there is one more tough issue that is easy to put off: picking one child as your successor while ensuring you are being fair to all your children.

All of these issues are difficult to deal with. Because it takes time to thoughtfully address these issues, planning for your succession is – by necessity – a process rather than an event. Also, given that most of the major decisions to be made are of a personal nature, the process used to manage each family's business succession will vary greatly depending on the nature of the family issues involved. Consequently, there is no one approach that will work for all business owners.

The succession planning process – an overview

In broad terms, the business succession process involves the following stages:

1. Determining whether business succession within the family is a viable alternative,
2. Developing your succession plan,
3. Monitoring the implementation of the plan, and making changes as necessary, and
4. Coordinating your succession plan with personal tax planning for retirement and the distribution of your estate.

Each of these steps is equally important. For example, excellent succession plans can be ineffective if they are not properly implemented and sophisticated estate plans can become ineffective if they are not coordinated with a business owner's plan for succession.

Though we've said it before, it can't be stressed enough that succession planning is a process. The success of the process will depend on a number of factors, including: a desire to make it work, healthy family relationships, and trust, honesty and openness among family members. Though matters of family communication are beyond the scope of this bulletin, your BDO advisor can suggest strategies for improving

family communication and can offer advice regarding other professionals you might turn to for help conducting family meetings and setting up a family council.

Is succession a viable alternative?

Determining whether succession to a family member is a viable alternative seems an obvious first step but doing so is not always straightforward. Many business owners do not carefully consider all the issues when deciding whether succession to a family member is a viable alternative.

Business owners often have a plan in their own mind – take the case where one of the children has been active and effective in the business. In such a situation it may seem obvious to you what's going to happen – that child will succeed you. But the goals and objectives of the child may not be in harmony with this plan. Alternatively, some children may be overlooked as a successor because their views and general outlook on business issues differs greatly from that of the founder (due to human nature, we often relate better to people who share the same style and values).

In many cases, problems can arise right at the beginning if you do not deal appropriately with two key questions:

1. Are my children interested in succeeding me?
2. Are my children capable of running the business when I retire?

To deal with these questions fully, both communication and objectivity are important. When it comes to communication, have you actually asked your child whether he or she wants to succeed you? And if you have, are you sure he or she was truthful in his or her response (knowing how strongly you feel about the business)? Objectivity in terms of assessing your child's ability to run the business is also important.

Assessing a child's interest in the business

When assessing a child's interest in your business, it's important to keep in mind that it is often difficult to be objective during this process. You have devoted a great deal of time and resources to developing the business and, quite naturally, you should be proud of what you have achieved. Chances are your feelings toward the business are obvious to other members of your family, which creates potential problems for some business owners:

- ◆ Business owners may find it difficult to accept that a child does not share his or her interest in the business, and
- ◆ A child of a business owner may find it difficult to communicate to the parent that they really are not interested in succeeding them in the business.

For many families, one of the best ways of working through these potential problems is with the help of an

outside family business advisor. Family members, especially children of the business owner, may be more willing to share their feelings about the business, both pro and con, with an independent advisor. The role of an advisor at this stage is to help facilitate information gathering within the family, usually by interviewing family members individually and by then facilitating open discussions between the family members.

Assessing a child's ability

Succession will only work if your business is passed on to a child who has the skill to run it. Where there is one obvious interested candidate, the process is more straightforward – you can focus on evaluating that family member's abilities. Even if you believe the process will be straightforward, it's worth keeping in mind that a family business advisor can be helpful with this task, as the advisor has more experience in assessing strengths and weaknesses of prospective successors, and such advisors bring objectivity to the process. Even if the advisor simply confirms that you have made a wise choice regarding a prospective successor, the advisor may be helpful in pointing out areas where the successor's skills can be improved. Another valuable benefit to involving an advisor is that, depending on your relationship with your child, recommendations made by a third-party often can be more effective or are more warmly received because they do not have emotional strings attached.

Choosing between interested and capable children

The process gets far more complicated and difficult to deal with when more than one child is interested in, and capable of, taking over. In fact, having to choose among possible successors is often one of the main reasons many business owners do not deal effectively with the issue of succession. As parents, we try to treat all children fairly, which usually means treating them as equals. However, when it comes to succession, the reality is you will likely have to pick one child to be your successor.

It is possible to pass on control of your business to various children as partners, but the success rate for this sort of arrangement is generally not good, and to pull it off, your children will need a strong sense of trust and harmony as a group. We discuss this issue in more detail in the next section of this bulletin under the heading "Going with a group". In most cases, however, it is best to choose a single leader.

Because many parents can't bear the idea of rating the strengths and weaknesses of their children, this is again a good time to bring in outside help. An advisor can help you make sure your business is passed on to the child best equipped to handle it. Also, an outside business advisor will bring objectivity to the process. As discussed earlier, if one of your children uses a management style similar to your own, it may be difficult

for you to be objective when comparing that child to another child with a different management style.

Building objectivity into the process may also help your children deal with the succession process. Though the children who are not chosen may still find the decision difficult to accept, the fact that objectivity was brought to the process should help make the choice easier for all to deal with.

Going with a group

Earlier, we set forth the reasons why choosing a single leader is usually recommended. There are, however, some structures involving the sharing of control that have been successful for some families. There are two basic approaches that have been known to work:

- ◆ ***Family partnerships*** – Family partnerships can work if each child is a full partner and the partnership agreement specifies that complete consensus is required for all important decisions. This alternative works in situations where the children see each other as equals and there is a strong desire among the children for succession of the business within the family. If a single leader is chosen and other children in key positions with the business do not accept the choice, the conflict created could destroy both the family and the business.
- ◆ ***First among equals*** – In an alternative we call “first among equals”, one child has more control over most day-to-day decisions, but important, fundamental changes are decided on by the group. In this situation, the boundaries of the leader's responsibilities should be clearly defined and disclosed to all.

The success of both arrangements will depend on shared vision and a strong enough bond among the children that will allow for successful teamwork. The children will need to adopt a balanced approach to building consensus, as very few business partners will agree on everything. As one would expect, the family partnership arrangement is the more difficult of the two to successfully implement.

It should also be noted that the skills required to make these arrangements work don't come naturally to most people. To help smooth the process, the use of a family business advisor as a facilitator can be valuable, particularly in the early stages.

Another approach that some families consider is the idea of rotating control among the children. Though this approach appears to deal with the issue of fairness, it is often a poor business decision. Becoming a leader of a business is a learning process and rotating leadership among a group will more than likely mean the business constantly has a leader in training. In addition, from a customer's point of view, the business can appear to lack clear direction if each successive leader takes the business in new areas.

What happens if you can't identify a successor?

After working through the process of determining whether any of your children have both the desire and capability of succeeding you, you may decide succession within your family just won't work. You could reach this conclusion for a number of reasons, including, for example:

- ◆ None of your children are either interested or capable.
- ◆ A child has the potential to succeed you, but is not yet ready.
- ◆ You have children who are equally interested and capable, but you feel selecting one child over others is not worth the risk of disharmony within your family (or your potential successor may not want to take on the job, given the feelings of the other family members).

Alternatives to passing the business on to a family member

If you conclude that passing the business on to a family member won't work, take heart (and don't think that there's no point in engaging in business succession planning)! There are many other options to ensure the value of your business is not lost or squandered:

Sell the business – After all the issues are considered, the best option may be to simply sell the business, either to third parties, or perhaps even to your employees. Once you have decided that a sale is the best alternative, you and your BDO advisor can make plans about how and when to sell, so that you maximize the value of your business. You can establish an estate plan around the proceeds you will receive from the sale of your business. Remember, passing on the business to new owners is really just another form of business succession.

Split the business – If you own a business that is involved in several different activities, splitting the business into autonomous divisions may allow you to deal with the issue of selecting among equally qualified children. Also, doing so allows you to assign each division to the child best suited to deal with that specific part of the business.

Use an interim chief executive – If you feel a child will eventually become a qualified successor, an interim leader can help keep the business going until the child is ready. The leader can also act as a mentor to your child as he or she prepares to take over. There are a number of points you'll need to keep in mind, however:

- ◆ While an interim chief executive is at the helm, your family will not be involved in the day-to-day activities. Therefore, you should establish a management structure within the family to monitor the business and to oversee important business decisions.
- ◆ It will take a unique individual to assume this role – they will need a wide variety of skills including strong leadership ability and a willingness to step aside when the time comes.

- ◆ You will obviously need to have complete trust in this individual, as you are giving them a significant amount of control over a major family asset.
- ◆ As it is unlikely the interim leader will have a stake in the business, the individual will expect to be well paid for his or her services, perhaps with the use of performance bonuses and other incentives designed to compensate for lack of ownership.
- ◆ As we discuss in the next section, retaining key non-family employees is important in any succession plan, but it is especially important if the business will be controlled by an interim leader. The leader will need the skill and experience provided by these employees. Consequently, creative remuneration systems and bonuses for key employees may also be called for.

Take the company public – Another option that may be available for larger businesses is a public share offering. Taking a company public provides three main advantages. First, the potential market for shares of your company will be greatly increased. Second, the shares of many companies are worth more immediately following a public offering than they were when the company was private. And finally, a public offering allows a much higher degree of flexibility for estate and tax planning, as you can sell your shares in smaller blocks over time (which is difficult for shareholders of a private company). Of course, just as there are advantages to taking a company public, there are disadvantages. Your BDO advisor can discuss with you the advantages and disadvantages of going public, and can help you find other advisors to work with you on the going public process.

Succession plan development and implementation

Once you have decided that family succession makes sense, the next phase is to develop a plan, and begin its implementation. Given that the succession plan should be tailored around the unique characteristics of both your family and your business, every succession plan will be different. Consequently, rather than outlining a specific plan you should use, we'll look at several elements that are common to most successful plans:

- ◆ clearly identifying your successor and his or her role,
- ◆ transitioning your successor aboard,
- ◆ accepting the necessity of a succession plan,
- ◆ keeping the succession plan as open as possible,
- ◆ establishing a clear timetable for the process,
- ◆ developing a clear business plan that extends beyond your retirement,
- ◆ seeking outside advice,
- ◆ retaining key non-family employees, and

- ◆ realization that fairness is not synonymous with equality.

Clearly identifying your successor and his or her role

To be effective, your succession plan should clearly identify who will succeed you and what their role will be. For example, simply transferring the shares of your business to your children and allowing them to decide how to run the business is not a succession plan and doing so has a poor chance for success. It will be much easier to effectively transfer control of the business if family members fully understand their current and future role in the business.

Earlier in the bulletin, we pointed out that most successful succession plans involve the designation of one overall leader. Most family businesses are successful when compared to larger organizations because of the presence of a strong leader, which often translates into an ability to make important business decisions quickly to capitalize on opportunities as they arise. Consequently, there is a strong bias toward having a clear leader, even though there is potential for disharmony within the family.

Transitioning your successor aboard

Once the successor is named, the goal becomes making sure the successor will be ready to take control when the time comes. There are several ways to meet this goal, including:

- ◆ **Allowing your successor to participate in business decisions** – In the beginning, you will likely maintain control over major business decisions. However, early on, you should allow your successor to be involved, passing on more responsibility for important decisions as time passes.
- ◆ **Meeting key business contacts** – It will be useful for your successor to see how you manage relationships between your business and important customers, suppliers and other key business contacts. In addition, introducing your successor will also be beneficial to these parties, as it gives them an opportunity to become comfortable with him or her.
- ◆ **Allowing your successor to work in different areas of the business** – In many cases, the best way to learn about the business is to be directly involved in different areas of it. Be careful, however, to select the work experiences so as to ensure the experience gained is a valuable learning tool.
- ◆ **Gradually allowing your successor to assume your duties** – Once your successor has a good knowledge of your business and has been involved in decision-making, the next step is to gradually pass on your responsibilities.

Accepting the necessity of a succession plan

Like several other issues discussed in this bulletin, this point seems obvious, but there is more to it than first meets the eye. A succession plan is a plan for change – therefore, for the plan to be successful, the business owner must accept that there will be major changes as the implementation of the plan proceeds. So, for example, the founder must consciously accept that, over time, the chosen leader will become responsible for more business decisions and may take the business in new directions.

The founder keeping a tight rein on decisions made by the successor or exhibiting an unwillingness to change are sure signs that the founder has not totally embraced the idea of succession. This can create a great deal of frustration for both the founder and the successor and could ultimately cause the successor to move on to other pursuits.

Keeping the succession plan as open as possible

As with any important plan, the succession plan will have a much better chance of being successful if everyone involved has a clear understanding of the plan in general and of each person's role in particular.

The first step in creating an open plan is to ensure the plan is written and is made available to all those directly involved in the succession process. For those not directly involved, communication is still important. The bottom line is the succession plan should be discussed with all who will be affected by it. This means disclosure should go beyond your family – key non-family employees, key customers, lenders, and other key business contacts should be aware of your plans.

During discussions with those directly involved, consider going beyond the details of the plan itself. For example, rather than just telling those involved what decisions have been made, it may be useful to explain why certain decisions have been made.

Also, always keep in mind that the way you communicate is important, especially with respect to discussions within the family. Most family business advisors recommend planning meetings specifically to discuss the succession plan and other issues facing the business. This allows family members to focus their attention on the issues facing the business. In addition, it's a good idea to hold these meetings away from both your home and office, as this often helps participants focus on the issues at hand.

On the flip side, many family business advisors warn that you shouldn't talk about business outside of these meetings, for example, at family functions, because doing so may make those not involved in the business feel isolated.

Establishing a clear timetable for the process

When developing your plan you should ensure it includes a clear timetable so those involved know

exactly what will be expected of them and when. Vague time references should be avoided. For example, if your plan merely states that it is your intention to continue working until the day-to-day responsibilities become too much to handle, your successor will be left uncomfortably waiting for the inevitable – your illness or death.

At a minimum, definite dates should be set for the following events:

- ◆ retirement of the business owner,
- ◆ transfer of share ownership, and
- ◆ transfer of voting control.

Many business owners will want to retain voting control and ownership until death, though they are comfortable giving up day-to-day control before then. The key is to make sure everyone involved is aware of your intentions and the time frame.

One final point to keep in mind is that once you have set a specific timetable you should stick to it. If the timetable is not followed, the credibility of the entire plan will suffer greatly in the eyes of all involved.

Developing a clear business plan that extends beyond your retirement

A clear plan and direction for the business will be of great benefit to your successor. It's a good idea to develop a business plan that extends beyond your retirement. In addition, involving your successor in the development of the plan will be a valuable learning experience for him or her. Though your successor may take the business in a different direction in the future, a detailed business plan will get him or her off to a good start.

Seeking outside advice

Obtaining outside advice during the succession process is crucial for most business owners, especially for founders. Being able to discuss the issues you are facing with others who have been through the succession process is invaluable.

In addition to traditional family business advisors, many family businesses find that reporting to a board of directors or advisors can be very useful, both in the succession process and in business management in general. When choosing board members, it's especially useful to include non-family members. Outside board members can help to:

- ◆ *Maintain focus on business goals* – Just the process of preparing reports for the board will help add focus for those involved.
- ◆ *Identify new ideas* – Outside board members can bring new ideas and insight to the business. In fact, when choosing board members, try to name members who have different skills from your own, or who have knowledge of areas you've identified that could be improved.

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- ◆ **Contribute impartial feedback (positive and negative)** – It is difficult to be objective about any issue when you are involved in the introduction and development of new ideas. Outside board members can bring a fresh outlook to these issues. In addition, non-family board members can be used as a sounding board for new ideas.
 - ◆ **Add professionalism to the business** – The process of meeting with a board regularly, reporting to them, and receiving feedback will add professionalism to the business. However, to maintain the professionalism that can be created when choosing prospective board members, it is generally a good idea to exclude close friends.

Retaining key non-family employees

If you have non-family employees who are key to the business, keeping these employees during the succession process will be extremely important. Though the first issue is to ensure that these employees are fairly remunerated, there could be other important issues to deal with as well. It is worth keeping in mind that key employees may feel they are working for you rather than for the company. As a result, it is important they are informed on the succession plan, its progress and its affect on them.

In addition, it is important that key employees have respect for your intended successor. Though this respect will have to be earned over time, it can actually be won or lost before the succession process begins. Consequently, the application of a few simple rules of thumb can pay dividends down the road when the succession process begins:

- ◆ **Encourage your children to work outside of your business before joining** – In addition to enhancing the credibility of your children in the eyes of non-family employees, there are other benefits as well. For example, the child may develop a higher level of self-confidence and may be in a position to bring new views and ideas to the business.
- ◆ **Avoid premature promotions of family members** – If it appears to employees that a child has been promoted before his or her time, then both you and the child will lose credibility. Even if the child later proves capable, the loss of credibility will be difficult to recover.
- ◆ **Where possible, try to treat family and non-family employees equally** – Your employees will obviously realize that family members do enjoy a special status as employees of the business. However, making an effort to treat all employees equitably will benefit you and your successor in the future in terms of things like productivity and loyalty. So, to ensure that employees are treated equitably, it's a good idea to: pay reasonable salaries to all employees based on work performed, carry out performance reviews for both family and non-family employees, and involve

both family and non-family members in key decisions, where appropriate.

Realization that fairness is not synonymous with equality

When developing a succession plan, treating your children fairly does not necessarily mean your children should be treated equally. Earlier we suggested that it is generally a good idea to choose one leader because having the business run by your children as equals often does not work.

Besides considering who will run the business, you also need to carefully consider who will own the shares of the company. For most parents there is a temptation to split the ownership of your business equally. However, before making this decision, there are some issues worth considering.

Equal ownership places a large burden on your successor. Every major business decision has an affect on the value of the business. If you have been the sole owner of the business you enjoyed the successes, and perhaps suffered through some failures, alone. However, if you decide on equal ownership among family members, your successor will carry a much greater burden. He or she will be responsible for maintaining the value of the business for each member of the family. Even with full analysis and prudent judgement, some business decisions simply don't pan out. This can add a great deal of stress on your successor.

Equal ownership can also create feelings of animosity between your successor (as well as other family members actively engaged in the business) and family members who are not active. Those individuals working hard in the business may resent the fact that they must share the growth arising from their efforts with inactive family members.

There are ways to deal with this problem, even where the investment in your business is your largest asset. For example, if your business owns its own premises, it may be possible to separate the real estate from the business and leave the real estate to inactive family members. Or, as we discuss later, insurance can be used to create an instant estate to help equalize the division of your assets.

Other business planning strategies to consider

In this section we highlight a few planning strategies that may be useful to you in implementing your succession plan. Even if you are not actively considering succession planning at this time, these strategies may be beneficial to your business. Your BDO advisor would be happy to discuss how these strategies may be useful in your situation.

Shareholder agreements

If you are transferring ownership of your business, either directly to family members as part of your will or as part of an estate freeze, (which is discussed below), a shareholder agreement is an important tool you should consider. A shareholder agreement is an agreement that governs the conduct of the shareholders and it should address all areas of possible concern. With such a broad mandate, the possible contents of a shareholder agreement are endless.

Each business will have different concerns, and the importance of the issues will vary. But, in general, a shareholder agreement for a family business usually deals with the following key issues in addition to more general business concerns:

Share ownership rules

For many family businesses, the rules that govern who can own shares are the most important part of the shareholder agreement. Specific areas that should be addressed include:

- ◆ ***Who will be allowed to hold shares of the business?***
In most cases, ownership will be restricted to family members. For example, many shareholder agreements prohibit in-laws from becoming owners.
- ◆ ***What happens in the case of marital breakdown?***
Most provinces provide for family property equalization on marital breakdown. Therefore, where the shares of a family business constitute a large proportion of a couple's property, there is a chance that some shares can become property of the soon to be ex in-law. There are several ways a shareholder agreement can deal with this. For example, the agreement could require that, as a condition of becoming a shareholder, each family member must have a marriage contract that specifically carves out the shares from the category of family property. Or, the agreement can provide that the shares must be immediately offered for sale to the rest of the family on marriage breakdown.

Buy/sell rules

A shareholder agreement should also include rules regarding where and how shares can be transferred. For example:

- ◆ ***Can shares be transferred to non-family members?***
There are two basic scenarios that should be addressed: a sale of shares by one family member and a sale of the entire business by all family members. For a sale by an individual family member, the agreement can be restrictive – for example, it could state that all shares must be owned by the family, so only transfers between family members will be allowed. Another option would be to allow for a sale of shares to non-family members, but would require that the shares must be offered to the rest of the family first. For a sale of the entire business, you may also want some special rules. For example, for the approval of such a sale, will a

simple majority be sufficient or should a higher threshold be set?

- ◆ ***How will the shares be valued?*** As most agreements will allow share transfers at least within the family, the agreement should set out rules for valuing the shares. Note that the valuation method chosen must be reasonable to avoid potential tax problems.
- ◆ ***New shareholders must be a party to the agreement*** – Where share transfers are allowed, the agreement should also require that the new shareholder must sign on to the shareholder agreement as a prerequisite for share ownership.

Disability of a shareholder

The agreement should address the procedures to be followed when a shareholder becomes disabled, especially where that shareholder is an employee. In particular, the agreement may provide for disability payments, and perhaps a requirement that the shares be sold to other family members in the case of prolonged disability.

Death of a shareholder

Finally, the agreement should set procedures to follow on the death of a shareholder, including consideration of the following:

- ◆ ***Can shares be transferred to the shareholder's heirs on death?*** Depending on the succession plan for the family business, the family may want to restrict who, if anyone, can inherit shares on death. If there is a requirement that the shares must be sold or redeemed, insurance can be used to provide the funds required.
- ◆ ***Use of proceeds from corporate-owned life insurance*** – Where the corporation holds the life insurance on the business owner, the shareholder agreement should set out how this insurance is to be used. For example, the insurance proceeds could be used to redeem the deceased's shares or can be paid to other family members to buy shares from the deceased's estate. You'll want to discuss the use of insurance with your BDO advisor.

This is by no means a complete list of issues you should address in a shareholder agreement. The agreement should also provide rules that will help you deal with any other issues you think might arise. By setting out the ground rules in advance in a shareholder agreement, the potential for family conflict will be lessened in the future when these issues arise.

Preserving your assets

Asset preservation is critical for family business owners because most forms of business involve risk. As an owner-manager, there are a number of steps you can take to protect your business assets. For example:

- ◆ If you own the real estate used in your business, you may want to consider holding this real estate in a separate holding company. If business risks arise in

the operating company, the real estate may be sheltered from these risks.

- ◆ A holding company can also be useful if your business generates cash flow in excess of amounts required for business investments and cash paid to you as a salary or dividend. If a holding company holds the shares of your operating company, the excess cash can be paid to the holding company as a dividend on a regular basis, and again this cash may be protected from risk in the operating company. The inter-company dividend generally will be tax-free.
- ◆ If you need to borrow money for the business, investigate all your alternatives before borrowing personally or giving personal guarantees. Though arranging for financing using personal resources is often the fastest way to raise cash for a new venture, there is risk associated with committing personal funds.

Retirement planning and estate planning considerations

Retirement planning and estate planning go hand-in-hand with succession planning – and should be considered at the same time – because all three relate to planning for your future and your family’s future. Retirement planning is especially important for business owners because they often pour money earned through the business back into the business rather than taking out enough (in salary, bonuses or dividends) to save for their own retirement. Indeed, the founder’s financial needs in retirement are often a critical factor driving other succession plan issues, such as timing of the founder’s exit from the business and the structuring of business ownership. Succession will likely fail if funding the founder’s retirement puts too great a strain on the business, so retirement planning should start as early as possible.

Estate planning, on the other hand, is usually aimed at maximizing the value of your assets (including the preservation and protection of property during your lifetime) and minimizing and/or deferring tax and other costs arising on your death. As well, estate planning is meant to provide for an orderly transition of assets to your beneficiaries and usually includes providing for your dependants. Once you have set your succession plan, you should ensure your estate planning goals are coordinated with this plan.

First we’ll look at some general retirement planning issues/ideas and then we’ll look at some estate planning techniques that are especially useful for business owners.

Retirement planning

Financial peace of mind is crucial for enjoying retirement. For business owners there are two distinct

ways of engineering this security: creating personal savings by drawing funds over time from the business or “saving within the business”, which involves reinvesting cash flow in the business to make it more profitable in the hopes that there will be more in the business to pay out at retirement or the business will provide higher proceeds if sold.

There are advantages and disadvantages to both. Withdrawing money from the business over time allows you to diversify your investments and it offers flexibility, but you will have to pay tax on salary and dividends withdrawn from the company and draining cash from the company may be financially dangerous to the company. Saving within the company may be advantageous because business returns should be higher than portfolio returns you might earn, but this technique carries higher risk, since any business is generally riskier, and risk management is not always possible.

There is no right or wrong answer to the question of how best to provide for your retirement – you will have to decide what you are most comfortable with and what makes the most sense in your situation. But the important thing to remember is that as the owner of a business, you do have flexibility when it comes to creating a source of income in retirement, and you should consider each of these retirement savings options when planning for retirement:

- ◆ **Maximize RRSP contributions** – If you receive a salary from your corporation, this salary will be earned income for the purpose of making RRSP contributions. As discussed in our *Answering Your RRSP Questions* tax bulletin, you can contribute 18% of your previous year’s earned income up to a maximum amount for the current year, less your pension adjustment (PA) for the previous year. For 2009, the maximum amount is \$21,000 (increasing to \$22,000 for 2010, then indexed for subsequent years), less your PA for the prior year (if you are a member of a pension plan).
- ◆ **Pay yourself a retiring allowance** – You can make an additional contribution to your RRSP on retirement by having your corporation pay you a reasonable retiring allowance (which the company can deduct). Provided that you worked actively in the business before 1996, a retiring allowance paid to you can be transferred to your RRSP, up to the following limits:
 - \$2,000 for each year of service before 1996, plus
 - \$1,500 for each year of service before 1989, provided that you were not a member of a company-run pension plan.
- ◆ **Use an Individual Pension Plan** – It may be possible to set up a pension plan for yourself, and other family members, known as an individual pension plan or IPP. For older business owners, the potential retirement benefits provided by an IPP can greatly exceed the benefits provided by regular RRSP contributions. The rules are complicated,

however, and these plans are more costly to run when compared to a conventional RRSP.

- ◆ **Redeem freeze shares in retirement** – In the next section on estate planning, we talk about estate freezes, which are a technique that basically freezes your gain in the company and allows future value growth to go to your children. Generally, as a result of an estate freeze you will hold fixed-value preference shares after the freeze. Once you retire, these shares can be redeemed over time, providing you with dividend income from the corporation. Such redemptions will also reduce the accrued gain that will be taxable on death.
- ◆ **Sell shares to family members** – Rather than having your shares redeemed, you can sell your shares to other family members (but not to a corporation they own). Such a disposition would be taxed as a capital gain rather than a dividend. Tax rates on capital gains are lower than the rates on ineligible dividends and in some provinces they are lower than the rates on eligible dividends.
- ◆ **Use a holding company** – As businesses grow in size, it is common to have multiple shareholders. Where the cash flow needs of shareholders vary, a holding company can be useful as a retirement savings vehicle. For example, if you receive dividends that you don't need for current cash needs, it may make sense to hold some shares through a holding company, as it may be possible for the company to receive dividends on a tax-free basis. As discussed earlier, such a plan also protects excess cash from business risk.

As we said, given that there is risk associated with all businesses, it is usually prudent to use some or all of the methods discussed to save for retirement. Remember, if the business should fail or experience cash flow problems, it is important for you to have other sources of income to fall back on.

Estate planning techniques

As previously mentioned, once you have set your succession plan, you should then ensure that your estate planning goals are coordinated with this plan. When coordinating the estate and succession planning, balance is critical. There are many tools you can use to maximize your estate, but you also need to ensure that the steps you take do not have a negative effect on your succession plan. In the rest of this section, we discuss estate planning considerations within the framework of a succession plan.

In many respects, family business owners face the same estate planning issues as individuals in general. Consequently, all of the issues discussed in our *Estate Planning* tax bulletin may apply to an owner of a business (a copy can be obtained from your BDO advisor, or from our website at www.bdo.ca). However, as the investment in the business is usually the most

significant asset held by most family business owners, there are a number of important estate planning issues they need to address.

Freezing the value of your shares

As we discuss in the *Estate Planning* bulletin, an individual is generally deemed to dispose of his or her assets at fair market value at the time of death. Exceptions to this rule include the transfer of property to your spouse at their tax cost and an intergenerational rollover that is available for certain transfers of qualifying farm and fishing property.

Where a tax rollover isn't available, at the time of death you will be subject to tax on accrued gains on your assets, including your investment in the business. For many business owners, the investment in the business will have a high value and a low tax cost, which means that without planning, a significant tax liability will arise on death. This problem is compounded by the fact that the asset generating this liability is generally not liquid. The tax liability for most non-business owners, on the other hand, often is dealt with by liquidating investments to pay the tax.

Finding a way to reduce, or at least defer tax, on death is crucial if the business is to remain in the hands of the family. Most business families use two important estate planning tools to deal with this issue – an “estate freeze” and life insurance.

Defer tax with an estate freeze

Though it is difficult to reduce the tax payable on gains that have already accrued, there is a common technique, called an “estate freeze,” that you can use to limit your capital gains in the future. By freezing the value of your investment, future gains will accrue to shares held by your heirs and the gain won't be taxed until they sell their shares (or have a deemed disposition on death).

In addition to ensuring tax on future gains will be deferred, an estate freeze will allow you to effectively lock-in the tax liability that will arise on your death (subject to changes in tax rates in the future). By locking in the tax liability, you can plan ahead to ensure this tax liability can be met without disrupting the business. For most businesses, life insurance is an excellent tool for providing liquidity on death.

How does an estate freeze work?

There are many ways to accomplish an estate freeze. One common method is to transfer the assets you wish to freeze, such as shares of your operating company, back to the operating company in exchange for fixed value preferred shares of the operating company. This transfer can be accomplished on a tax-deferred basis using tax rollover rules.

Your heirs (or a trust for their benefit) can then subscribe for the new growth shares (generally common shares) of the operating company. At the time of the estate freeze, the value of these common shares would be nominal, but as the value of the business grows, this

growth will accrue to the new common shares held by your family or a trust.

In many cases, a business owner will actually take back two classes of shares on an estate freeze – the preferred shares we just described, plus a special class of non-participating voting shares. By holding these shares, you can retain control over the corporation, provided the special voting shares carry more votes than the new common shares. This will be especially important if you intend to have your preferred shares redeemed over time.

You can also freeze your estate by using a trust. Under this alternative, you can transfer the assets you wish to freeze to a trust whose beneficiaries would be your intended heirs. This allows future growth to accrue to your beneficiaries without giving them control over your assets.

The major difference between using a trust and a corporation for an estate freeze is that it is generally not possible to transfer property to the trust on a tax deferred basis. Consequently, tax may have to be paid on any accrued gains on the assets at the time of the transfer. For this reason, this form of an estate freeze is not common for an owner of an established family business. However, if accrued gains are small or the gain arising from the transfer can be offset with a capital gains exemption claim, freezing with a trust can be advantageous, as assets held in the trust will not be subject to the deemed disposition rules that apply on death. It should be noted, however, that for tax purposes assets held by a trust are subject to a deemed disposition at fair market value every 21 years.

When to freeze?

To maximize your deferral, an estate freeze should be carried out as soon as possible, as this will limit the accrued gain on your shares and ensure that future growth accrues for the benefit of your children. However, before you freeze, there are two important issues you need to address:

1. If you freeze the value of your shares now, will this leave enough value for you to live on in the future?
2. Has the timing of your estate freeze been properly coordinated with your succession plan?

When dealing with the first question there is an important point to keep in mind. Though it may be possible to undo (or "thaw") an estate freeze, it is generally a good idea to assume you might not be able to access the future growth of the business to support yourself. Consequently, if you're not sure how much wealth you need to keep, there are two fairly simple alternatives to a full estate freeze:

- ♦ ***Defer the freeze*** – For younger business owners, especially those with young children, if you're not sure how much wealth you need to keep, it may make more sense to simply defer the freeze until you have a better idea of your future needs. At this point, however, you may still want to determine the tax

that will eventually be payable and purchase some life insurance to cover the projected liability.

- ♦ ***Use a partial estate freeze*** – When you freeze, there is no requirement for you to give up all of your common shares. Therefore, you can choose to freeze only a portion of your holdings. This will allow growth to start accruing for the benefit of your children while allowing you to retain an interest in future growth for yourself. If you're sure you won't need all of the expected future growth in the business for yourself, but you still aren't ready to give up all of the growth, a partial freeze makes sense. Also note that once your future plans become clearer, you can implement a second estate freeze in the future.

A partial freeze can also provide an added benefit. Though we have focused on the use of an estate freeze as part of an overall succession plan, a partial freeze can allow you to multiply the availability of capital gains exemptions, should you decide to sell the business. Where a family trust holds common shares, the gain arising from these shares can be allocated by the trust to your children. Your children may then be eligible to offset some or all of the gain with a capital gains exemption claim.

More sophisticated plans can give you more flexibility as well. Ask your BDO advisor for more information.

Coordination with your succession plan

For an effective estate freeze, your children have to own at least some of the common shares of your company, either directly or through a trust. But as we discussed earlier, depending on your succession plan, you may want your successor to have a greater interest in the business than other children who will not be active. Consequently, you'll need to consider this when planning for an estate freeze.

As most business owners are reluctant to turn over full ownership of common shares to their children (especially if they are minors), a family trust is generally used to hold the new growth shares until they are ready to turn over ownership to the children. If the trust is discretionary, the division of the common shares among your children can be deferred. However, even with this flexibility, the timing of your estate freeze is still important.

Family trusts are a powerful planning tool, but they also have limitations. One important limitation is the 21-year deemed disposition rule. Under the tax rules for family trusts, your trust will have a deemed disposition every 21 years. Therefore, if the trust still holds the shares 21 years after the estate freeze, the trust may be subject to tax on a capital gain equal to the gain that has accrued over the 21 years.

Will you be in a position to divide the common shares among your children in 21 years?

In reality, most trusts don't actually pay tax on accrued gains due to the deemed disposition, as there is a way to defer its taxation. If the trust transfers ownership of the shares to your children before the first 21-year deemed disposition, this transfer will occur at the tax cost. Consequently, the taxation of the accrued gain will be deferred until the child disposes of the shares. Because of these rules, prior to carrying out an estate freeze it is important for you to determine whether you will be in a position to divide the common shares among your children within 21 years.

This is an important question, and highlights why the coordination of your estate freeze and succession plan is so important. For example, if your children are very young, they will only be in their early to mid-twenties when it comes time to divide and transfer the shares of the corporation. At that age, it may not be possible to identify a successor, and therefore, decide on how the shares should be divided.

The two options described earlier – deferring the freeze or using a partial freeze – are also effective ways to address this issue. By deferring the estate freeze, the first 21-year anniversary of the trust will also be deferred, and hopefully by that time you will be able to finalize your succession plan. A partial freeze can also be useful if you're sure that all of your children will receive some shares. You can use a partial freeze immediately and do an additional freeze later for the shares that will be transferred to the child who will be named as your successor.

The best method for you will depend on a number of factors. Discuss these issues with your BDO advisor.

Using insurance

As discussed earlier, life insurance is a powerful tool when used alongside an estate freeze. For many business owners, other than selling the business, insurance provides the only real option for dealing with the income

tax that will be payable at death. Once you freeze your estate you can purchase enough insurance to pay the projected tax liability.

Life insurance has a second important use in estate planning for family business owners. As discussed earlier, we suggested that treating your family fairly doesn't necessarily (and often does not) mean treating them equally when it comes to your business. In particular, splitting the shares of a family business equally among children who have varying degrees of involvement in the business can cause problems. To avoid these problems and still be fair, insurance can create an "instant estate" that can be used to provide for children who are not active in the business.

There are several ways insurance can be used for this purpose. For example, the insurance proceeds can simply be paid as an inheritance to children who are not active in the business. Or you can bequest shares to all of your children and the insurance proceeds can be made payable to the corporation, which will use the proceeds to redeem shares held by non-active family members. The best plan for you will depend on several factors, such as the relative number of active and inactive children and the value of the business compared to the value of the estate as a whole.

Summary

We have discussed many issues in this bulletin. In planning for your future and your business' future, the decisions you need to make may seem overwhelming. It is important to keep in mind that succession and estate planning are not events, but processes. As such, these issues are best dealt with over time with the help of your BDO advisor. With our help – and an early start – you can beat the odds and ensure that your family business continues to thrive in the future.

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