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Masters Series

Business Succession: It's Never Too Early To Start Planning

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Strategies

THIS IS ONE OF A SERIES OF ARTICLES PREPARED FOR CIBC. THE SERIES IS WRITTEN BY PROFESSIONALS IN FIELDS SUCH AS TAXATION, TRUSTS AND ESTATES.

Whether retirement from your business is imminent or years away, it's never too early to start making plans for the future. A business succession plan allows you to take steps to help preserve the value of your business and ensure that there is a smooth transition to new ownership. Business owners should ask themselves, "What do I want for my future, my family, and my business?" Your plan needs to cover all contingencies, not just retirement.

Hope For the Best, Plan For the Worst

The best-case scenarios reflect your personal goals — do you want to continue working full-time indefinitely, or retire in five years and leave the business to your children? You need to consider how your personal goals will affect the future of your company, and make that the foundation for your business succession plan.

Unfortunately, you also have to plan for the worst-case scenarios. If you became incapacitated tomorrow and were unable to work, you would want to know that your family and your business would be secure. You need to ensure that you are not the only person who holds key information about the business, its customers, and key processes, so that the business can continue successfully without you. You may also want to establish a cash contingency fund or take out insurance to add a financial "cushion" for the business during any time of transition.

Your business succession plan should address the following:

Ownership issues. Do you intend to sell your business to a third party, leave it to family members, or wind it up? Having your business properly valued will help clarify your options.

Management issues. Who will run your enterprise? Developing a management succession plan now allows you time to groom a successor and pass on the information and skills needed to carry on the business successfully.

If your business is family-run, emotional ties may make these decisions more difficult. You may want to consult an external professional (such as a lawyer, accountant, or other estate planning specialist) to help you.

Tax implications. Capital gains taxes arise when a business changes owners, including the change of ownership that occurs on death. If your business is a qualifying small business corporation, your shares may be eligible for a capital gains exemption of up to $800,000.

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If your business is larger, or does not qualify for the exemption, the deemed disposition at death may trigger a sizable taxable capital gain. Unless there are sufficient liquid funds to cover the estate's tax liability, your family might be forced to sell the business. Alternatively, insurance can provide funds to pay taxes.

One possible solution is to institute an estate freeze while you are alive. This allows you to freeze the value of the business at the current date and the amount of capital gains taxable on a subsequent sale or upon your death. Future capital growth in the business accrues to your children.

Buy/Sell Agreements

If you are a co-owner of a closely held corporation, you and the other shareholders should consider implementing a buy/sell agreement. This legally binding document establishes the conditions by which one owner can purchase the other owner's shares. It plays an important role in protecting the remaining owners when one owner dies, becomes disabled, or no longer wishes to participate in the business. Partnerships face similar business continuation issues, and partners should also consider implementing a buy/sell agreement.

A buy/sell agreement usually includes the following details:

Triggering events. What events trigger the right of one shareholder to buy the other shareholder's shares? Triggering events typically include death, retirement, and disability, but they should be specifically identified and carefully defined in the buy/sell agreement.

Whether the purchase is compulsory. Once the triggering event occurs, is the other shareholder required to purchase the shares, or just given an option to do so? A mandatory purchase provides greater certainty to your planning.

Valuation method. How will a price be determined for the shares of the company? The shareholders may agree on the value of the business on an annual basis, or a defined method of calculation may be used, such as a multiple of earnings.

Funding. How will the shares be paid for? Typically, there are three methods of providing the cash to carry out the buy/sell provisions. Owners can set up a pool of assets for this purpose, they can borrow against the assets of the business when needed, or they can arrange for applicable insurance coverage. There are a number of different methods to structure insurance to provide the necessary funding. Each method provides different advantages and tax consequences.

Review Your Plan Regularly

It's important to review your business succession plan at least once a year to make sure that it accurately reflects your current wishes and situation. Here are a few examples of situations in which you may need to make changes to your business succession plan:

- **Your personal or business goals have changed.** Do you want to retire earlier? Has your choice of successor changed?
- **Tax laws have changed.** For example, if the $800,000 lifetime capital gains exemption is amended or your shares no longer qualify for it, you will need to revisit your strategies.
- **The nature of your business has changed.** Perhaps you have taken advantage of a favourable purchase offer for all or part of the business from a third party, or you've expanded the business into new areas. If so, your original business succession plan may no longer be appropriate.

An Integrated Approach

Your business probably represents a significant portion of your total net worth. As a result, your business succession plan will also have a major impact on your personal estate plan. It's important for the two elements to work together. For example, if you plan to leave the shares of your business to one of your children upon your death, you might want to leave non-business assets of equivalent value to your other children. Like your business succession plan, your estate plan should be reviewed and updated regularly so it keeps pace with your changing needs. Professional advice can be very helpful in making your estate plan and business succession plan work in harmony to achieve your objectives — today and in the future.

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