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Tax for the Owner-Manager

SUCCESSION PLANNING IN UNCERTAIN ECONOMIC CONDITIONS

Many Canadian family businesses are suffering under the economic and market pressure brought about by COVID-19, but such circumstances may actually present unprecedented succession, estate, and TOSI (tax on split income) planning opportunities.

Consider, for example, a family business (Famco) that had a market valuation of $3 million before the COVID-19 pandemic. Famco is in the goods-selling business and is solely owned by Mom. Mom has two adult children, Son and Daughter, both over the age of 24. Son is active in Famco's business but Daughter is not. Mom wants to pass the business to Son while providing financial security to Daughter and retirement income to herself. Although a traditional estate freeze plan has always been an effective way to meet Mom's objective, the economic downturn turbocharges the usefulness of a freeze and may introduce options that were previously unavailable. For the purposes of illustration, assume that the FMV of Famco has dropped 40 percent to $1.8 million. (We are not business valuators, and the prolonged uncertainty makes valuation a more difficult [and more dispute-prone] exercise than ever, but we believe that it is probable that the value of many Canadian businesses has fallen materially since the COVID-19 pandemic began.)

In the example, Mom can execute a traditional freeze whereby she freezes the value of her $1.8 million holding in fixed-value preferred shares. Son and Daughter (or a family trust) can acquire nominal-value voting or non-voting common shares. This structure is already a much more powerful freeze than one executed at a pre-pandemic value of $3 million. If Famco's business and value rebound after the pandemic, all of the value accretion over $1.8 million will be streamed out of Mom's hands (and out of her estate on her eventual death) and into the hands of the next generation. Wasting-freeze strategies can provide retirement income to Mom through periodic share redemptions by Famco, further reducing her future estate's value. As well, this structure provides opportunities to maximize any available capital gain exemptions among family members. This is a good result, but the lower valuation provides other potential planning opportunities.

A family member who holds "excluded shares" (as defined in subsection 120.4(1)) and has attained age 24 before the relevant time may earn unlimited dividends or capital gains on those shares without TOSI applying even if he or she is not active in the business. One of the requirements for excluded shares is that the individual hold shares representing 10 percent or more of the votes and value of the corporation. The lower valuation makes this target more accessible. Prior to the COVID-19 pandemic, for both children to avoid TOSI via the excluded-shares exemption, each would have had to make a $300,000 investment to meet the 10 percent value threshold. Now, only $180,000 is required to achieve excluded-shares status, provided that other excluded-shares requirements are met. Although Son can likely rely on the excluded-business exemption to avoid TOSI in any case, the family may want both siblings to be on equal footing in terms of investment. Note that excluded shares must be held directly by an individual, so the implications of non-tax issues (such as creditor exposure and an inactive family member having voting shares) must be considered.

Each of the children may make the $180,000 investment from his or her own funds or may borrow from a financial institution. Alternatively, Mom can gift cash to the children to fund the purchase; attribution does not apply to gifts to children over 17 years of age. If Mom loans cash to the children, however, a proper prescribed-rate loan arrangement is necessary to avoid attribution under subsection 56(4.1). The prescribed rate of interest was reduced from 2 percent to 1 percent as of July 1, 2020.

If Mom wants additional liquidity, she can sell some of her Famco shares to the children on a taxable basis. The lower valuation today means a smaller taxable gain. If Mom is willing to take a promissory note from the children that is payable over several years, she can claim the capital gain reserve pursuant to subparagraph 40(1)(a)(iii) to spread the tax over 5 years (or 10 years under subsection 40(1.1) if Famco shares are QSBC shares). Note that if Mom claims the reserve, the children's basis in their Famco shares will be restricted for section 84.1 purposes because of subsection 84.1(2.1).

Interestingly, even if the children are unable to raise the capital required to make the $180,000 investment or purchase, nominal-value common shares issued to them on the freeze could quickly reach the 10 percent value threshold if the value rebounds after the pandemic. In Famco's case, an increase in value of $360,000 would result in each child having the 10 percent of value shareholding that is required for excluded-shares status.

Suppose that the family had executed a freeze of the Famco shares before the COVID-19 pandemic. Results similar to those described above can be achieved by thawing the old freeze and refreezing at today's lower value. The new valuation may be subject to more CRA scrutiny than the valuation of a regular freeze, and the CRA has previously stated (in CRA document no. 2000-0029115, November 17, 2000) that it may consider a benefit to have been conferred on a refreeze if the decrease in value of the freezor's shares was the result of a stripping of corporate assets.

Another planning consideration is a purification of Famco's assets if necessary to comply with the QSBC conditions. If Famco has built up significant non-business assets that have suffered a loss in value, executing a purification now will cost less in tax. If this action triggers a capital loss in Famco, any positive capital dividend account (CDA) balance should be paid out prior to the realization of the loss. If the asset transfer triggers a capital gain, business losses of the current year will shelter the gain, but the non-taxable portion of the gain will still increase the CDA.

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