IG PRIVATE WEALTH MANAGEMENT

Tax and Estate Planning for Business Owners

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Business owners sometimes say, “My business is not complex or big enough to warrant a tax and estate plan.” But quite often this is not the case – when a plan is implemented, its value is maximized even before it is truly needed. Think about it. If we do not worry about creditor protection until there is a known creditor threatening to sue, or we do not plan for the succession of the business until there is a medical emergency, fewer planning opportunities may be available.

> Having a plan in place today can help ensure that your assets are protected, your business carries on profitably, and your wealth potential is maximized.

Planning within a corporate structure

A tax and estate plan is just that, a plan! Without proper planning, good intentions are often just not enough. You, as a business owner, have put significant time, resources, and effort into making your business successful. So how do you proceed with protecting that value? A proper tax and estate plan works with you and your business throughout its life cycle to ensure you are maximizing wealth and minimizing taxes, both now and in the future.

A business can be operated using three types of structure: sole proprietorship, partnership, and corporation. Tax and estate planning affects all business owners, but, as most profitable businesses are incorporated, we will focus on tax and estate planning considerations within a corporate structure. These include income splitting, creditor protection, and succession planning.

Income splitting

Directing income from your business to members of the family who participate in the business can be an effective strategy for reducing the family’s overall tax bill.

If you extract additional cash from the corporation, that income is taxed in your hands, typically at the higher marginal tax rates. Paying a salary to a member of your family may be an option, but there are restrictions. Salaries paid to a principal shareholder who also manages the business (commonly referred to as an “owner-manager”) are not subject to reasonability tests, but salaries paid to members of the owner-manager’s family are – meaning that you can only pay a salary for work performed, and the salary has to be reasonable compared to a salary you would pay to a non-family member. This can limit the ability to income split your family.

However, if the owner-manager's spouse and children are shareholders of the corporation, or beneficiaries of a family trust that owns shares, they can receive dividends from the corporation, and those distributions would not be subject to the Canada Revenue Agency's (CRA) reasonability tests applicable to salaries. Provided the spouse or adult children work on average at least 20 hours per week in the business, the dividends will be taxed in their hands, often at a marginal tax rate significantly less than the owner-manager's. As of January 1, 2018, expanded rules on split income have made income-splitting with family members more complex. Understanding these rules is important because when family is actively involved in the business, it is important to contemplate income splitting opportunities when setting up or reorganizing the corporate structure.

Ideally, the company's articles of incorporation should allow for multiple classes of common and preferred shares for added flexibility in the paying of a dividend to one shareholder versus another. Income splitting share structures allow you to financially assist your actively involved family, without you paying significantly more in taxes. Note that the tax on split income continues to discourage the distribution of dividends from a private corporation to or for the benefit of related persons who will not attain the age of 18 in the year of payment, regardless of their involvement in the business.

Family trusts and their use in the corporate structure

Often the idea of income splitting conflicts with the notion of having family members as direct shareholders of the corporation. A family trust can be a great way to limit direct control over the shares of the corporation, while still providing a potential opportunity to income split with family members. It is a relationship created by a settlor with trustees to hold and manage property for the benefit of the beneficiaries of the trust. The trustees make the day-to-day decisions about the affairs of the trust, keeping the beneficiaries' interests in mind.

When a trust is being established to hold and manage shares of a private business, the settlor is typically a friend or relative to whom the owner-manager makes a small gift that is necessary for the legal creation of the trust. Settling the trust in this manner allows the owner-manager to be a trustee of the trust, as well as a beneficiary together with other members of the owner-manager's family. Being a trustee provides the owner-manager with a say over the trust's assets (which would include the shares of the operating company).

Family trusts are typically introduced as part of an "estate freeze," allowing the trust to subscribe to common shares of the operating company at a nominal cost. Most family trusts are discretionary in nature, meaning that any distributions of income and capital to the beneficiaries are at the discretion of the trustees.

This flexibility allows dividends received by the trust to be allocated only to those family members who the trustees believe require the funds. The trustees can also use the trust funds to pay for expenses that benefit one beneficiary over another. If the trust is no longer required or beneficial, the shares can generally be transferred to capital beneficiaries on a tax-deferred basis (see "An alternate organizational structure" on page 8).

Family trusts and multiple capital gains exemptions

If an owner-manager is the sole shareholder of a profitable, qualified, small business corporation and is able to sell those shares, the resulting capital gain realized on the sale may be sheltered by the lifetime capital gains exemption (LCGE), which is $971,190 in 2023. However, if the value of the business exceeds the capital gains exemption available, a portion of the sale of the shares will be taxable to the owner-manager.

One of the benefits of having shares of a qualified small business corporation held by a family trust is that the family trust can allocate a capital gain resulting from the sale of the shares to multiple beneficiaries, including minor children. Those beneficiaries can use their LCGE to reduce or eliminate the taxes payable on the capital gain. If a capital gain of $3.8 million is realized on the sale of shares and that gain is allocated equally to four beneficiaries of the trust, no tax should be payable if each beneficiary has their full LCGE available.

Family trusts are all about flexibility and control. Trusts allow the present generation of owners to determine if and how the next generation will benefit from the income and value created in the business.

Tax planning for professionals

Corporations will not shield a professionals from liability for their professional advice and service. However, as with other forms of business, there are significant tax advantages to incorporating a profitable professional practice. Low corporate tax rates can allow business debt to be repaid faster and create the opportunity for enhanced retirement savings.

Corporations are also used to facilitate income splitting with members of the professional's family. It's important to note though that in the provinces of Alberta, Ontario, and Newfoundland, laws governing most of the professions prevent shares of a professional corporation from being owned by family trusts and holding corporations. While the restrictions in these provinces, as well as new restrictions imposed by the expanded tax on split-income provisions, make planning more challenging, corporations may still be a valuable tax-planning tool.

> *"Does your corporation have multiple classes of shares, allowing the directors to sprinkle dividends in varying amounts among your actively involved family to maximize your after-tax family income?"*

Creditor protection

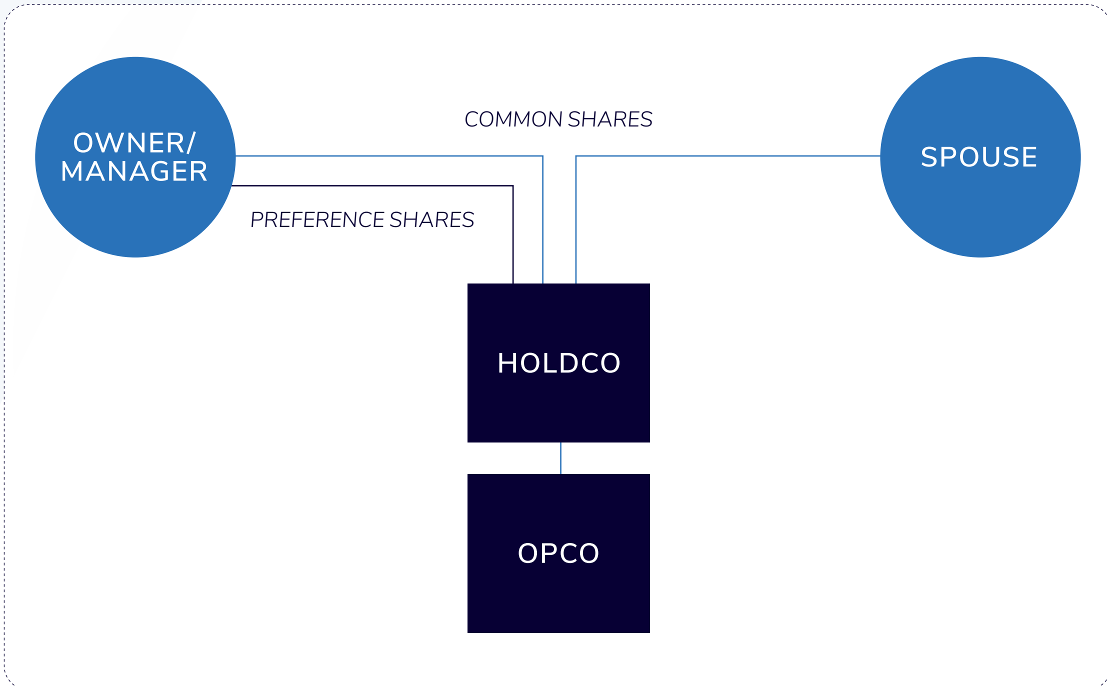
There are two types of creditors: known and unknown. Your bank, credit card company, and supply vendors are all known creditors and are part of normal business operations. It is the unforeseen creditor that leaves the profits of a business vulnerable.

Creditor protection essentially involves the removal of excess corporate profit out of the operating company so it is protected from unforeseen creditors.

If the shareholders do not need the excess cash, the withdrawal of the funds personally would defeat the tax deferral of the corporate structure – in this situation, a holding company is the solution.

Unlike dividends distributed to an individual shareholder, tax paid income can generally be paid as a dividend tax-free to a holding company. A holding company is a separate corporation, and as such, if the operating company (Opco) is sued, the assets of the holding company (Holdco) typically remain protected (see "Holding company structure" on page 7).

HOLDING COMPANY STRUCTURE



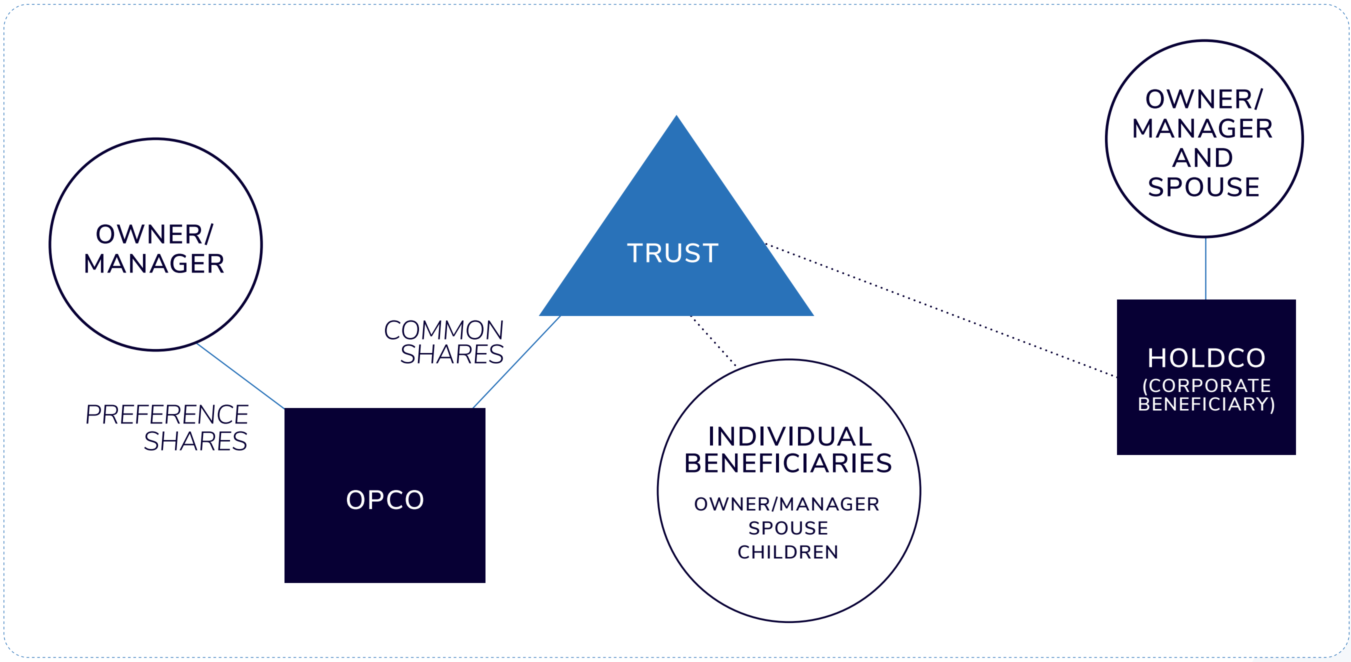
Once the cash is in the Holdco, there are a number of options, such as it being invested for the future (often retirement) or used to pay insurance premiums. If Opco needs the cash for operations, creditor protection can still be accomplished. In this case, Holdco lends the money back and attaches a general security agreement to the promissory note issued by Opco. Holdco then becomes a secured creditor ahead of unforeseen unsecured creditors. This allows the cash to be utilized by Opco in its operations, but the value of the dividend originally paid still remains protected as though the cash remained in Holdco.

Holding companies can sometimes function like a bank when a business becomes self-financing. Profits can be distributed tax-free to the holding company and then loaned back to the operating company under a general security agreement – just like a bank would do – protecting the value you have built in your business.

A holding company is usually not put in place until the operating company is successful, as it can be costly to maintain if there are no earnings to protect. It is never too late to add a holding company to the corporate structure.

Often an election under subsection 85(1) of the Income Tax Act is utilized to transfer the individual's shares of the Opco to a Holdco on a tax-deferred basis, resulting in the individual holding shares of Holdco instead of Opco. This structure can be suitable if it is unlikely the shares of the operating company will ever be sold. But if a share sale is probable, better alternatives exist.

AN ALTERNATE ORGANIZATIONAL STRUCTURE



Alternate organizational structure – a better mousetrap

A structure being used more than ever by owner-managers is one under which the common shares of the operating company are held by a family trust, and the beneficiaries of the trust include a holding company (typically owned by the owner-manager and their spouse).

In any year where the operating company's profits are not required for distribution to individual beneficiaries of the trust, the trust can allocate the income to the corporate beneficiary (Holdco). Holdco receives the income tax-free as an inter-corporate dividend and can use the funds for investment purposes.

With this structure, not only do you ensure profits are protected from unsecured creditors, but since excess cash can be removed from the operating company to Holdco with ease, the operating company shares remain eligible for the lifetime capital gains exemption.

Recent legislative changes have made creditor-protection strategies more complex. Consultation with your professional tax advisors is imperative prior to the payment of dividends to a holding company to ensure that any dividend paid to a connected corporation maintains its non-taxable status. Additionally, new rules on passive income can result in a loss of the small business deduction limit for corporations operating an active business. Therefore, it is important to consult with your professional tax advisor to determine whether retaining passive assets in your corporate structure works for you.

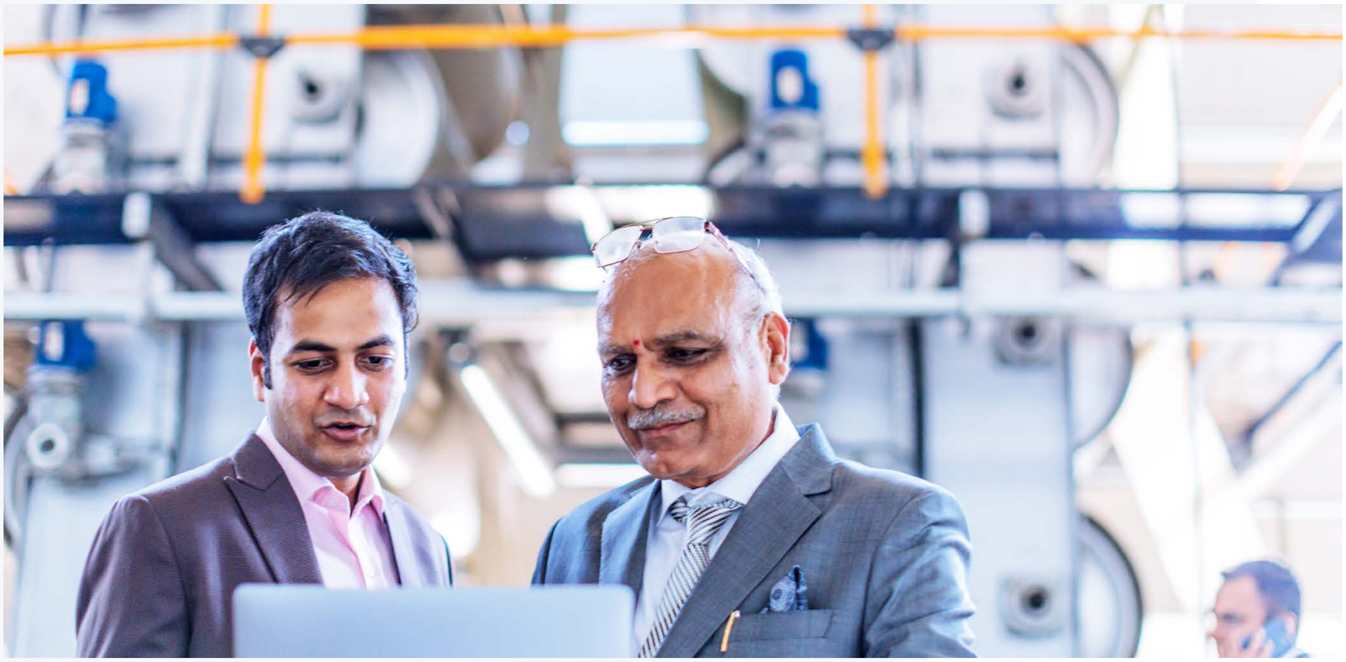
Succession planning and estate freezes

A key aspect of estate planning is asking: How does the business pass to the next generation? Various considerations are taken into account in deciding if and when to hand the business over to the next generation.

As part of the planning process, the owner-manager needs to consider if the estate is liable for tax. Upon death, you are deemed to dispose of any capital property held (which would include shares of the operating company) at fair market value. If there are accrued gains on that capital property, the estate may have taxes payable (assuming LCGE is not available or sufficient). Hence, the owner-manager should always be aware of the value of the estate and the associated tax consequences and, when that value is significant, consider the need for an estate freeze.

An estate freeze is a mechanism whereby the value created to date is “frozen” in the form of fixed-value preferred shares, and the next generation then becomes the new common shareholders. This allows for all future value (and the applicable tax liability) to move from the owner-manager to the next generation. There are multiple ways to accomplish an estate freeze.

The questions for the owner-manager then become: How much value is enough? And how do I limit my estate tax liability while still maintaining control of the company, if the next generation has not yet proven itself in the business? The following summarizes three of the many options available to the owner-manager to accomplish an estate freeze and bring in the next generation.



Types of freezes

COMPLETE FREEZE	PARTIAL FREEZE	COMPLETE FREEZE WITH A FAMILY TRUST
• Owner-manager exchanges their common shares for fixed-value preferred shares • Next generation or key personnel subscribe for new common shares at a nominal value • Future growth attributes to the new common shares • Owner-manager can retain the preferred shares for dividend income potential or redeem them over time for additional cash flow needs • Voting control can stay with the owner-manager in the form of voting preferred shares or can pass to the common shareholders	• Same as complete freeze except owner-manager subscribes to a portion of the new common shares along with next generation and/or key personnel • Future growth attributes to the new common shareholders (owner-manager is still participating in new growth but is now sharing among other shareholders) • Next generation can learn the business with the owner-manager, and everyone is rewarded for their efforts in the form of share value • Voting control typically stays with the owner-manager in the form of voting preferred shares	• Owner-manager exchanges their common shares for fixed-value preferred shares • Family trust subscribes to new common shares at a nominal value • Future growth attributes to the new common shares • Once the next generation has proven itself, the trust can allocate all or a portion of the common shares to the beneficiaries who will take over the business • Owner-manager can retain the preferred shares for dividend income potential or redeem them over time for additional cash flow needs • Voting control typically stays with the owner-manager in the form of voting preferred shares

> *The risk with any estate freeze is freezing too soon. From a wealth accumulation standpoint, there is a balance between managing estate tax liability and knowing how much you will need to finance your post-retirement years. Without a family trust, an estate freeze can be difficult to undo.*

Family trusts and their use in succession

Two questions are often difficult to answer when looking at estate freezes and succession planning: How much is enough, and is the next generation ready for share ownership? The use of a family trust can help with both of these complex issues.

The family trust separates control of the new common shares, issued post-freeze, from the hands of the next generation by placing legal ownership with the trustees until the next generation is ready for the responsibility. The trustees are typically the owner-manager and the owner-manager's spouse (or another trusted person), ensuring that important decisions continue to be made by the owner-manager.

However, if a discretionary family trust (of which the owner-manager is a beneficiary) owns the new common shares issued as part of the freeze, the trustees can exercise their discretion to transfer some or all of the new common shares to the owner-manager. Family trusts generally provide a 21-year planning horizon, as the Income Tax Act will deem the trust to sell its capital property, including shares, at fair market value on the twenty-first anniversary of the trust. To avoid the tax consequence of a deemed disposition, immediately prior to the twenty-first anniversary the trustees will typically exercise their authority to transfer the common shares to beneficiaries, in whatever allocation the trustees consider appropriate.

Transfers of shares and other capital property from the trust generally occur at cost, thereby deferring tax. The shares held in the family trust can be transferred to the beneficiaries at any time and can be slowly distributed to the next generation as it demonstrates an ability to become shareholders. However, the desire to protect the company's shares from potential marital property claims made against the next generation often results in the trust maintaining control over the shares for as long as possible.

When should you consider an estate freeze?

1 | THE VALUE OF YOUR BUSINESS IS SUCH THAT THE GAIN ON YOUR SHARES EXCEEDS YOUR AVAILABLE LIFETIME CAPITAL GAINS EXEMPTION

2 | YOU ANTICIPATE YOUR BUSINESS WILL CONTINUE TO GROW IN VALUE

3 | THERE IS A GOOD POSSIBILITY THAT IN THE FUTURE YOU WILL EITHER SELL THE SHARES OF YOUR BUSINESS OR PASS YOUR BUSINESS ON TO ONE OR MORE OF YOUR CHILDREN

Post-freeze considerations

When the owner-manager has properly implemented an estate freeze, and the next generation has taken over, the next step can be to slowly eliminate the frozen shares (sometimes known as a wasting freeze). The fixed-value preferred shares can be systematically redeemed to provide the owner-manager and their spouse with a retirement income for the remainder of their life.

The wasting freeze is often done at a rate to maximize the use of lower income brackets and at the same time to avoid the claw-back of Old Age Security (OAS). Ideally, the wasting freeze can provide the right level of income for the owner-manager's lifestyle requirements during their remaining lifetime and reduce the overall tax liability resulting from death.

What if I decide to sell my business?

An added benefit of an estate freeze is the multiplication of the lifetime capital gains exemption, which can be accomplished even when the shares are held within a discretionary family trust. If the trust realizes a capital gain on the sale of shares, the trustees decide the portion of the proceeds, if any, to distribute to a particular beneficiary. Any portion of the taxable gain from the sale of qualifying small business corporation shares distributed to a beneficiary retains its character, allowing the beneficiary to utilize their personal lifetime capital gains exemption.

Benefits of an estate freeze with a discretionary family trust

1. IT LIMITS THE EXPOSURE OF THE CURRENT GENERATION TO TAX ON DEATH
2. IT MULTIPLIES THE LIFETIME CAPITAL GAINS EXEMPTION
3. IT ALLOWS INCOME SPLITTING WITH BENEFICIARIES 18 YEARS OF AGE OR OLDER WHO ARE ACTIVELY INVOLVED IN THE BUSINESS
4. CURRENT BUSINESS OWNERS REMAIN IN CONTROL AND CAN DEFER TO A MUCH LATER DATE DECISIONS REGARDING THE EVENTUAL OWNERSHIP OF THE BUSINESS

Will planning

A properly drafted will is one of the key documents used to ensure that your intentions and wishes are carried out upon your death. The will is also a key component of succession planning. As a business owner, you have a wide range of issues to consider when preparing a will.

Are there children who will take over the family business? Are there children who will not be involved in the family business? The answer to these two questions can have a significant impact on the distribution of estate assets. Often the business is the asset with the greatest value. If the will is drafted in such a way that all children receive a proportionate share of assets, all children will end up owning shares in the company.

When only certain children are actively engaged in the business and contributing to its success, this can often lead to conflict. However, if only certain children inherit shares of the company, the estate distribution can be unbalanced. Additionally, if there is a surviving spouse, how does he or she factor into the succession plan, particularly in a second marriage? Does he or she control the company? What if the company is the only source of income for the surviving spouse? The tax consequences of death will also be accelerated if shares pass to children immediately on the owner-manager's death.

These issues may seem insurmountable, but through coordinated planning that utilizes trusts within the will, and shareholders agreements and life insurance to fund any deficiencies, fair and cost-effective solutions can be found.

Trusts created upon death

You have carefully built a successful business and you want that wealth to be protected even after you have passed away. Testamentary trusts created as a result of death can be a way to control assets and wealth post-death, ensuring that beneficiaries are protected and assets are ultimately distributed according to your wishes.

SOME OF THE COMMONLY USED TRUSTS INCLUDE:

Spousal trust

This type of trust is often used in blended family situations where the owner-manager wants their spouse to still have income and possible access to certain assets during the spouse's lifetime, but does not want those assets to become part of the spouse's estate. If the assets were to form part of the spouse's estate, they would be distributed according to his the spouse's will and could pass to persons not of the business owner's choosing.

If the business owner has children from a prior relationship, the owner may want to ensure that the assets ultimately pass to those specific children. A spousal trust allows the surviving spouse to have access to the income from the assets held in the spousal trust during his or her lifetime – but upon his or her death, the assets are distributed to the beneficiaries identified under the terms of the business owner's will.

Disability trusts

If a child of an owner-manager suffers from a disability, a qualified disability trust allows for funds to be held in the trust, which can preserve the child's ability to be eligible for social assistance. Additionally, the trust ensures that the disabled child's wealth is controlled by trustees of the parent's choosing, reducing the risk that the child will be taken advantage of or their inheritance depleted.

Trusts for young beneficiaries

Often the thought of a young beneficiary receiving a large sum of money or shares of a corporation causes apprehension for an owner-manager. If there is concern that the individual may not be capable of handling the money until they are more mature, the inheritance can be held by the trust for the benefit of that individual, typically until they reach an age the owner-manager has determined is appropriate. The trust funds may be used to provide an income with assets being distributed in stages, allowing the young beneficiary to gradually achieve greater levels of responsibility with respect to the inheritance.

Discretionary family trust established by a will

If the source of funding for the trust will not include the shares of a private corporation but will come from insurance proceeds, portfolio investments, or from the sale of estate assets, a discretionary family trust established in the will can provide tax savings to assist your children – particularly in regard to expenses for their own children.

Typically, your children would be the trustees and can direct that trust income to fund expenses like private schooling, sport registration fees, music lessons, and post-secondary education for your grandchildren. This will allow the income to be allocated to, and taxed in, the hands of your grandchildren, even if they are minors, often resulting in little or no tax payable. This type of trust can also be an effective way to ensure assets are not at risk to marital property claims in the event of a divorce or separation.

Powers of Attorney

As part of the estate planning process, you need to ensure that a person or persons of your choosing can manage your financial affairs if you are not capable of doing so while still living. A power of attorney is a document under which this type of authorization is granted.

There are many different ways a power of attorney can be drafted, and powers may be broad or very specific with respect to certain assets or be limited in their duration. The provincial laws governing this type of document vary within Canada. If the owner-manager is still an owner of the business at the time the power of attorney is in effect, the attorney appointed generally has the power to vote the owner-manager's shares, but restrictions may be imposed under a shareholders' agreement, and additional steps will be required to allow the attorney to act in the owner-manager's capacity within the company.

Shareholder agreements

When you, the owner-manager, are one of several shareholders, the planning mentioned above can be negated if a proper shareholders' agreement is not in place. Business relationships are frequently started on a hand shake and work while the principal shareholders are living, capable, and getting along.

Shareholders' agreements can contain a variety of provisions to ensure the parties do not remain trapped if the business relationship sours, or if one of the principal shareholders dies or becomes incapacitated and unable to perform their duties.

Principal shareholders often do not wish to be in business with the spouse or children of the deceased shareholder. Without a properly written agreement, this can be the result of a shareholder's death. From the perspective of your family, a properly prepared and insurance-funded agreement provides certainty that in the event of your death or disability your family will be able to access the value you have built in the business.

"While shareholder agreements typically set out the division of duties and how decisions are made regarding financing, compensation and other important matters, a well-drafted shareholder agreement also deals with unexpected events."

Life insurance

Life insurance can be a useful planning tool in many different aspects of estate planning for the owner-manager.

Estate preservation

A common use for life insurance is to fund the tax liabilities resulting from death. Upon the death of an owner-manager (assuming no surviving spouse), the owner-manager is deemed to dispose of all of their capital property at fair market value – and this will include the shares of their company.

If the estate plan is predicated on succession occurring on death, the estate will need to be able to transfer the common shares of the company to the appropriate beneficiary. But if there are no other liquid assets, or those assets are required for estate distribution to other children, there will be a deficiency in the estate for its tax liability. To avoid the need to liquidate corporate or other estate assets, life insurance can provide a tax-free source of cash to fund those liabilities, leaving the estate assets intact and available for distribution in accordance with the will of the owner-manager.

Estate equalization

If estate value is concentrated in the shares of an incorporated business and not all beneficiaries will inherit those shares, life insurance proceeds can provide the estate with an additional asset that can enable estate equalization.

When the life insurance proceeds are required for equalization, managing the estate tax liability will be even more imperative. Therefore, understanding your estate value, distribution requirements, and taxation of the overall estate will be key factors when determining the appropriate level of life insurance coverage for your needs.

> *Understanding your estate value, distribution requirements, and taxation of the overall estate will be key factors when determining the appropriate level of life insurance coverage for your needs.*

Buy-out funding

Life insurance can be a cost-effective and tax-efficient means of funding the buy-out of non-participating family members, or the interests of other non-related shareholders.

When a shareholder dies, the remaining shareholders or family members actively participating in the business will often wish to continue ownership of the company without the heirs (or non-participating heirs) of the deceased.

Shareholders' agreements can be put in place (prior to death) for the sale of the deceased's shares directly to the remaining shareholders, or for the repurchase for cancellation (redemption) of the deceased's shares by the corporation. Life insurance can not only provide a cost-effective source of funding for buy-out agreements, but also minimize the tax consequences associated with death and the transfer of shares.

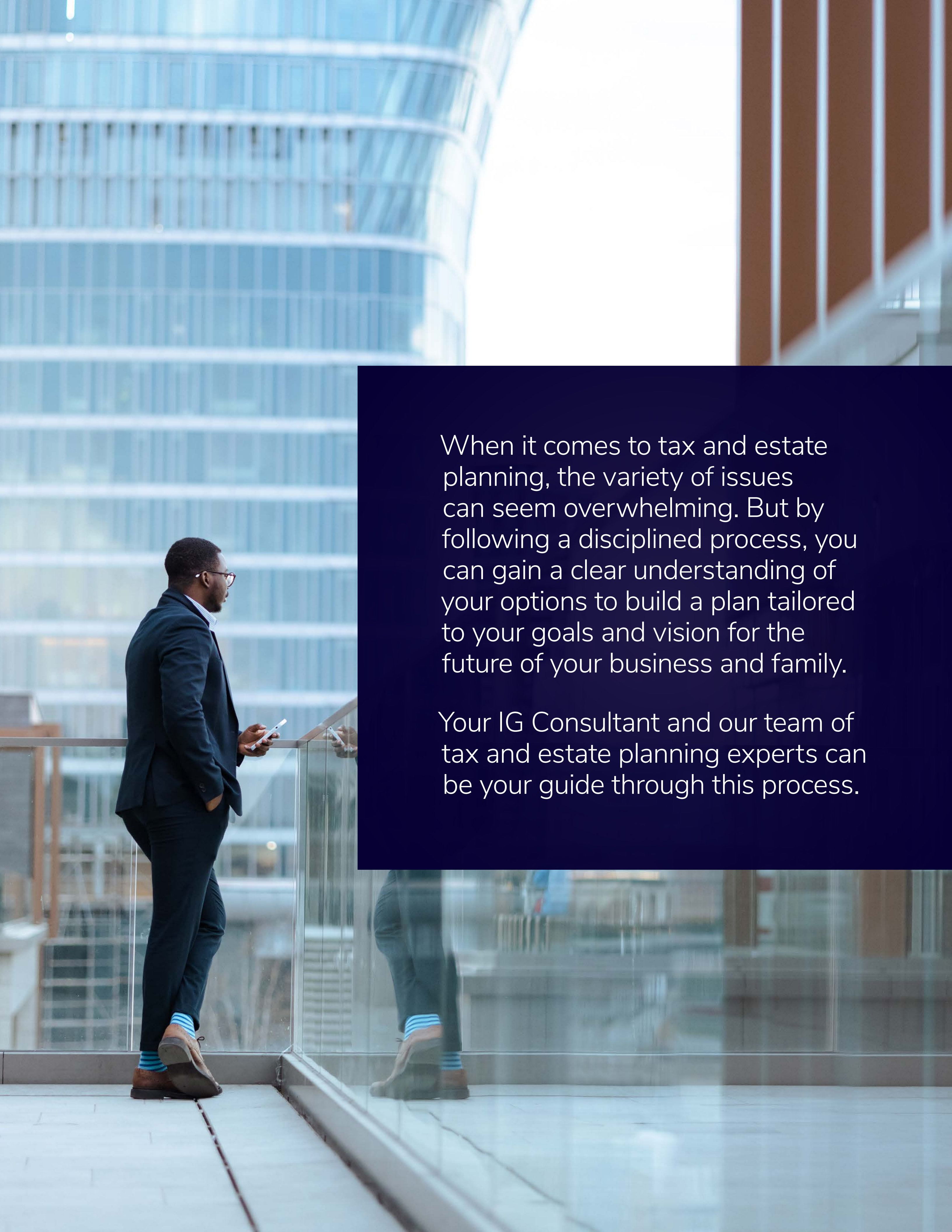
Tax savings are achievable because life insurance proceeds will be received by the corporation tax-free and through a mechanism known as the capital dividend account (CDA). All or a significant portion of the proceeds can be extracted from the company as a tax-free capital dividend.

A shareholders' agreement will typically outline that upon the passing of a shareholder, the life insurance proceeds received by the corporation must be used to fund the redemption of the shares held by the surviving spouse/estate. Upon the death of the shareholder, the shares would be redeemed, with the resulting deemed dividend declared as a tax-free capital dividend, resulting in a tax-free redemption.

Guaranteed retirement income and tax reduction

In today's environment, conservative investors are faced with low returns and high taxation. However, corporate insured annuities can guarantee the owner-manager will not outlive their money and at the same time will immediately and permanently reduce their tax exposure on death.

In comparison to a portfolio of Guaranteed Investment Certificates (GIC) held within a corporation, the combination of a corporate-owned accrual annuity and a minimum funded universal life policy can significantly increase after-tax cash flow in retirement. Net after-tax returns will also increase every year, providing a hedge against inflation. And on the owner-manager's death, life insurance proceeds replace the corporation's capital and can be extracted from the corporation with little or no tax consequence.



When it comes to tax and estate planning, the variety of issues can seem overwhelming. But by following a disciplined process, you can gain a clear understanding of your options to build a plan tailored to your goals and vision for the future of your business and family.

Your IG Consultant and our team of tax and estate planning experts can be your guide through this process.

At IG Private Wealth Management we believe in the power of financial advice to change lives for the better. We are committed to helping Canadians feel empowered about their finances and to improving their ability to achieve their personal financial goals by synchronizing all aspects of their financial lives through the IG Living Plan*.

For more information, please contact your IG Consultant.

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*To learn more about the IG Living Plan, visit https://www.ig.ca/en/why-us/living-plan