Some Income Tax Aspects of Succession Planning

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I. INTRODUCTION

A. PURPOSE AND SCOPE

The purpose of the following discussion is to set out some of the more important tax considerations in planning succession of a family business. Most of the discussion will focus on issues that arise on passing the business on to other family members. Some attention will be paid, however, to the steps that can be taken to optimize from a shareholder perspective the sale of a family business to employees or other non-family members from a shareholder perspective.

Many of the topics described here are or could be the focus themselves of long, technical explorations. That is not the intention here; rather it is a survey intended to identify, in very general terms, some of the issues and planning opportunities and some of the traps that can arise in using them or failing to use them. In many cases, I have provided references that the advising lawyer may wish to review in greater detail. These vary from relatively general discussions to technically complex ones and from brief papers to entire books.¹

There are also many specific topics not covered simply because the overall scope of the subject matter is too broad for coverage in a single paper. There is also a focus on the single corporate entity, and an abstraction from a holding company structure or a structure with parallel active business and passive asset subsidiaries. Finally, many of the planning steps discussed here could present issues in respect of the small business deduction acquisition of control which can have serious ramifications in a variety of circumstances. These must be considered in the formulation of any specific succession plan.

B. THE PRINCIPAL’S CIRCUMSTANCES AND OBJECTIVES

In order to further narrow the discussion, the following assumptions are made:

- The Principal is an Alberta resident for tax purposes and the owner of a successful

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business. Over time the business has appreciated in value.\textsuperscript{2} As a result, on a disposition of the business the Principal could be subject to capital gains tax unless certain steps are taken. For simplicity of discussion we have assumed that the business is carried on through a private corporation.\textsuperscript{3}

- The Principal is tax sensitive but not tax obsessed. Provided that it can be accomplished while substantially meeting the Principal’s other objectives, the Principal prefers to pass on as much of the value of the family business to family members. One mechanism for this can be minimization or deferral of capital gains tax and other income tax.

- The Principal is also concerned with preservation of the business and family assets generally. In certain circumstances, they will be concerned with potential attacks on personal or family wealth from third parties, from spouses of family members (sometimes their own spouse), from family participants in dependent relief or wills variation actions or from uncooperative participants, family or otherwise, in the family business.

For simplicity of exposition, most of the discussion assumes there is one Principal: most comments still apply if the Principal’s spouse also holds an interest in the entity carrying on the business. Some consideration is also given to the case where there are two or more unrelated owners.\textsuperscript{4} For any particular client some of these factors may be more important than others and for each of them the weight placed on factors will vary even among clients in similar circumstances.

C. CENTRAL TAX PARAMETERS

Many of the issues surrounding passing on a business within generations are tax related and in fact are tax driven.

\textsuperscript{2} It may also occur in the case of a corporation that was acquired under various rollover provision contained in the Income Tax Act (Canada) (the “Tax Act”) even where it has not prospered.

\textsuperscript{3} In some of the discussion there is reference to unincorporated businesses such as family farm businesses and family fishing businesses. However, in most cases discussion refers to a corporation that is a “Canadian controlled private corporation” for the purposes of the Tax Act (“CCPC”) and CCPC status should be assumed as a requisite for the application of many of the planning points.

\textsuperscript{4} All of the other individuals are Principals in their own right, with planning considerations likely similar to that of our Principal.
1. CAPITAL GAINS TAX

Either directly or indirectly the driving force behind much of succession related tax planning is the tax that arises on an actual disposition or a deemed disposition of the interest in the family business. As a general rule, where capital property is disposed of the amount if any by which the proceeds of disposition exceeds the adjusted cost base ("ACB") to the holder of the interest will be considered a capital gain, half of which will be taxable.\(^5\) The tax rate applicable to the taxable portion is 39%, meaning that the effective tax rate on the gain as a whole is 19.5%. All rates assume that the interest holder is resident in the province of Alberta. This paper will generally focus on situations where there is an inherent capital gain in the interest in the family business, and unless otherwise noted, any planning comments are directed.

While not particularly high from a global or inter-provincial perspective, funding the tax imposed a problem to the estate of a deceased taxpayer. Moreover, to the extent that the tax can be reduced or deferred, the other objectives of the Principal or their estate can become easier to attain.

As a general rule, under the assumption made, capital gains tax will arise on the actual disposition of the interest in the business (for example, sale of shares to family members or third parties). It will also arise, subject to various exceptions and "rollovers", on the death of the shareholder. There are certain ameliorating provisions and reorganizations or steps that can reduce or defer tax which will be discussed below.

2. DEEMED DISPOSITION ON DEATH

Under the Tax Act, subject to certain very important exceptions, where taxpayer dies they are deemed to have, immediately before their death, disposed of each capital property owned by them and received proceeds of disposition equal to the fair market value of the property immediately before death. Symmetrically, any person who has a consequence of the taxpayer's death acquires properties deemed to of been so disposed of by the taxpayer is deemed to acquire that property at the time of the death at a cost equal to its fair market value immediately before death.\(^6\)

Unless one of the exceptions applies, therefore, a capital property of the deceased taxpayer is effectively deemed to have been sold by them for fair market value. When that fair market value

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\(^6\) Subsection 70(5) of the Tax Act. Similar rules exist for eligible capital property, resource properties and certain other types of property.