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Canada edition

Succession Planning for a Family Business

By James Bowden | 21 November 2021

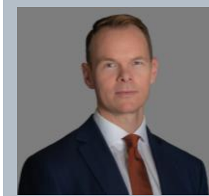
Planning for the succession of a family business is something that is too often delayed or addressed on an ad-hoc basis without a cohesive strategy. Considering that the business is likely the most valuable asset in a business owner's estate, and probably the most complex, it is very much worth the time and effort to develop and implement a plan for succession before life circumstances take these decisions out of your hands. This article will provide an overview of some of the tools available for family business succession planning, with an emphasis on what is known as an estate freeze. This article does not address the advantages and disadvantages of providing for the succession using a will, and focusses only on lifetime succession plans.

This article will assume the business is incorporated. If it is not, it is possible to transfer an unincorporated business to a newly formed corporation on a tax-deferred basis, so achieving corporate form is not usually a major obstacle.

The simplest approach to succession is for the business owner to make a simple gift of some, or all shares in the company to the intended successors during his/her lifetime. The gift approach keeps the shares out of the transferor's will and is simple and has virtually no cost associated with execution, but has little other benefit associated with it. It is the blunt instrument of wealth transfer. There are drawbacks to this approach, such as the fact that the gift will be treated as disposition at fair market value for tax purposes and tax will be payable on any capital gain that is deemed to have been realized. Also, the transferor would be giving up the value and control associated with the gifted shares, and there may be no way to backtrack once the gift is made.

Gifts can be made of only some of the shares, or new classes of shares can be created and issued to the successors in order to better customize their voting rights, participation in growth and entitlement to dividends. You may not wish to give your successors voting rights, or possibly even dividend entitlements, until you are prepared to exit from a leadership role in the company. In any

The Author



James Bowden
Managing Director - Toronto
jbowden@afridi-angell.com
Tel: +1 416 601 6815

James is an experienced transactional and corporate and commercial practitioner, having trained in both Ontario and with Afridi & Angell in Dubai for many years. He has developed significant expertise in a number of specialisations, most notably commercial advisory and transactional work, onshore and offshore trusts structures, asset protection, and tax and estate planning. James spearheaded the firm's initiative to establish its Toronto office (Afridi & Angell Professional Corporation), which he now heads, taking advantage of the firm's many Canadian ties and bringing the Afridi & Angell service standard to Canadian clientele. James is a member of the Ontario bar and received his L.L.B., from Queens University, Canada, in 2004.

scenario in which the company will have multiple shareholders, putting in place a shareholders' agreement is strongly recommended in order to avoid conflict. A shareholders' agreement should give clarity on matters of company governance, board participation, exit rights, what happens if the company is to be sold, what happens on death of a shareholder, how dividends will be dealt with, any expected contributions to the company from the shareholders, key issues for which unanimous or super-majority voting may be required, and how disputes will be managed (among many other things). In the family business context, a good shareholders' agreement can act almost like a family constitution, and can be critical to both the business and family harmony.

One popular succession planning technique is the estate freeze. An estate freeze is a restructuring of a corporation in which a business owner exchanges his/her shares in the company for preference shares that have a fixed redemption value and certain other specific attributes required by the CRA. The fixed value is usually equal to the fair market value of the company at the time. At the same time, common shares are issued to the intended successors. The growth in the company from that point forward will accrue to the common shares only, not the preference shares, which remain at their fixed redemption value (and may or may not have dividend entitlements, as desired). As such, the value of the business owner's interest (the preference shares) is said to have been "frozen" as of the time of the freeze. The share exchange is designed to occur on a rollover basis so that no taxable event is triggered, as the business owner has not actually extracted any remuneration from the corporation (just exchanged shares for shares).[1] On death, or upon an earlier disposition of the preference shares, the business owner will realize a taxable capital gain on the value of the preference shares. The estate freeze has several important advantages, which include:

- The value of the business owner's interest is frozen, so his/her tax exposure on death or disposition is known and will not increase (so this can be predictably insured against with life insurance, for instance);
- The future growth in value of the company is transferred to the successors, and this "transfer" occurs without tax because the value of the common shares issued to the successors is close to zero at the time of issue (the present value of future growth potential is not taxed, under current CRA practices);
- The lifetime capital gains exemption can be effectively multiplied among the successors, assuming the corporation's shares qualify for the exemption (meaning the corporation meets certain Canadian ownership and Canadian business and asset requirements, qualifying it as a "qualified small business corporation");
- Income splitting among the successors is possible if their shares are entitled to dividends (and if certain attribution rules are avoided);
- The successors are directly and personally invested in the continued success and growth of the business; and/or
- The business owner gets to enjoy witnessing the successors benefitting during his/her lifetime as opposed to dealing with the succession in a will.

An estate freeze is very often structured using a trust to hold the growth shares (common shares) for the benefit of the successor family members, rather than issuing the common shares to the family members directly. The trust then controls the shares subject to the terms of the trust instrument. This can be very useful as it allows the trust to act as a conduit through which the family members' respective interests in the underlying common shares is divided, and the nature of the division can continually change as needed. For instance, the trust can distribute dividend income among the beneficiaries in a manner that is most tax efficient in view of the different income brackets of the beneficiaries (income splitting, but not during the lifetime of the settlor/freezor as the TOSI (tax on split income) rules would apply) and this can change from

[1] If a business owner does wish to extract cash from the company, a tax liability will be incurred on the payment of such amount. It is often possible to extract such amount in the form of a capital gain.

year to year, and can withhold benefits during periods when a beneficiary is subject to creditor claims (asset protection). The use of a trust also allows the settlor/freezor to retain more control over how the shares will ultimately be distributed to beneficiaries, if indeed a distribution is intended at all, and to help protect the shares from potential spousal claims. It may not be obvious at the time of the freeze which of the beneficiaries is the appropriate successor(s), which ones have an interest in the business, the aptitude for it, etc. A trust allows for deferral of such decisions without deferring the economic transfer and crystallization of the tax benefits. Essentially, the trust facilitates continued flexibility in decision making in ways that direct gifting or direct ownership does not. As of the date of writing, the lifetime capital gains exemption can still be multiplied among the beneficiaries even when the growth shares are held through a trust. A shareholders' agreement should be put in place between the settlor/freezor and the trust.

There are many permutations on the estate freeze to accommodate a wide range of goals and circumstances. For instance, as part of the share exchange that occurs, a settlor/freezor may also choose to take back low value, super-voting shares along with the fixed value preference shares, so that he/she maintains voting control during his/her lifetime. These shares can be made to cease to carry such voting rights upon the settlor's/freezor's death so that control passes automatically to the family (or as provided in the shareholders' agreement). Another permutation is that the freeze can be structured in such a manner that only some of the future growth is transferred to successors (say, up to the amount of the lifetime capital gains exemption for each beneficiary, and no more), and the settlor/freezor retains the rest. Or, the settlor/freezor can retain the ability to receive dividends or to take back some of the growth shares in what amounts to a partial unwinding of the freeze (aptly known as a "thaw"), if circumstances change. This can be achieved by making the settlor/freezor a discretionary beneficiary of the trust. It is also possible to execute a second freeze on an already frozen company, known as a refreeze, which may be advisable if the value of the company declines after the first freeze, or if the recipients of the growth shares themselves wish to freeze the value of those in favour yet further recipients (the next generation, for instance). There are several other named permutations which are need not be addressed here, the point having been made that the estate freeze is an adaptable structure.

When structuring an estate freeze, particularly when using a trust, it is important to be very careful to structure it in a manner that adheres to the CRA's guidance on acceptable estate freezes, and does not trigger any of the so-called attribution rules in the Income Tax Act, and it is therefore important to execute a freeze only with the guidance of professionals who focus on trusts and have experience with estate freezes. The potential for inadvertent error is high, and the consequences of an error could be disastrous from a tax perspective (i.e., inadvertent attribution of all income and capital gains on trust property – being the common shares – back to the settlor/freezor, or the inadvertent application of the TOSI rules, or the inadvertent application of the corporate attribution rule). When executed correctly, the structure is safe and is not controversial from a CRA perspective; hence its popularity.

An estate freeze should be viewed as a flexible, customizable way of transferring ownership, control and economic benefits (as much or as little of each as is desired over time) in a family business to the next generation, in a tax efficient manner and with the added benefit of the continued flexibility offered by the use of a trust.

There are further permutations on the estate freeze that can benefit from the use of foreign trust and/or corporate structures established in low/no tax jurisdictions. For instance, foreign trusts can avoid being subject to the mandatory deemed disposition of all assets that applies to Canadian trusts every 21 years, and can therefore be made to last much longer than a Canadian trust, creating a much longer legacy. If the trust/corporation is established in a jurisdiction with which Canada has a tax treaty, there are potential additional benefits with respect to capital gains realized by the trust/corporation (e.g., Barbados and the United Arab Emirates). As always, planning with offshore trusts requires the assistance of professionals experienced in the area, as it is complex, but the advantages can be worth the additional planning in the right circumstances. It is worth noting that the media's unfortunate portrayal of "offshore" structures as illegal or immoral is misleading. Such vehicles have always been, and they remain as of the date of the writing, entirely legitimate planning vehicles under Canadian law when used correctly.

The above presents a selective review of potential succession planning techniques relevant to a private or family business. Within each option, there is large scope for customization according to individual needs and goals and family composition. The terms of any shareholders' agreement or trust instrument, or the rights attaching to any class of shares, can all be tailored to suit your specific circumstances. While there are tried and true structures that provide good basic starting points, succession planning for a business is not a cookie cutter process and always benefits from bespoke professional guidance.

If you have any questions or wish to discuss any issues around family business succession, please do not hesitate to contact us. ■

Afridi & Angell

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Afridi & Angell Professional Corporation, Afridi & Angell's Toronto office which was established in 2021, takes advantage of the firm's many Canadian ties and brings to our Canadian clients, and those with Canadian interests, the highest standards of advice and client service for which Afridi & Angell is known. Our Toronto office, which operates as a separate legal entity from Afridi & Angell's UAE offices, provides legal and advisory services in the following areas: corporate and commercial; mergers and acquisitions; tax planning and advisory; asset protection; private client and estate planning; anti-money laundering and anti-bribery compliance; IT outsourcing and contracting; consulting on Canada-UAE opportunities and cross-border legal issues.

Pending the launch of Afridi & Angell's Toronto website, please visit Afridi & Angell's main page at **www.afridi-angell.com**. Meanwhile please do not hesitate to contact **James Bowden** directly at jbowden@afridi-angell.com.