Progress

Article: Less is more

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On the surface, having too much money doesn't sound like much of a problem. Glibness aside, every business owner should be maximizing all of the tax savings they're entitled to, an effort that requires planning and knowledge.

"Many clients don't plan properly," says John Oakey, a tax partner at Collins Barrow Nova Scotia. Oakey says that maximizing tax advantages through succession and estate planning can be complicated when a business owner spends decades building a successful business without doing the right tax planning.

"The problem with contemplating succession and estate planning at retirement is that the value of the business may be entirely attributed to the single business owner, along with all respective tax consequences," says Oakey.

Assuming the business owner has a family, and the owner is engaged in timely professional tax advice throughout the years of growth, then the value of the business and its respective tax consequences can be appropriately shared among family members, resulting in significantly lower overall taxes. Ultimately, the earlier you start succession and estate planning, the more options are available for minimizing taxes at transition time.

There are plenty of pitfalls that come with fleshing out a good succession plan, and they're often complicated by family dynamics. Parents can't always fully relinquish control over the companies they've spent a lifetime painstakingly building, and children feel annoyed and intruded upon as they try to put their own stamp on things.

But family dynamics and egos aside, a key part of the succession buyout is simple mathematics. A common and accepted tax strategy is the creation of a family trust to properly allocate income and business value. "Each member of the family has $800,000 in capital gains exemptions," says Oakey. "If a business owner has a spouse and three children to allocate the proceeds of a business sale to, that's $4 million in potential tax-free capital gains.

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The question then becomes, did the business owner plan in advance in order to access $4 million in potential tax-free capital gains? Or is the business owner left with only $800,000 tax free?"

However, an existing business owner can't simply give away value that he or she has earned. That's where the trust comes in. "I've generated $5 million myself as a single shareholder of a company, and I have to keep that," says Oakey. "I can't give it away to my family without tax consequences. But a family trust implemented at the right stage of the business growth cycle allows some portion of that $5 million in value to attribute to my family members at my discretion." This can be an effective succession and estate-planning tool.

"You definitely want to look at your structure overall, at how you hold the ownership of your company," says David Jones, a senior financial advisor at Assante Capital Management Ltd. "It can give you insight into things like family trusts or, if you're making more money than you need to spend, it can give you access to saving higher after-tax dollars in the appropriate place by utilizing the small business deduction and possibly a holding company."

Leaving your money in the company means working with 86-cent dollars. But how you invest it while it's still within your company depends on how you've structured your business. "You can't save all of that redundant income in an active business and still qualify for certain things like capital gains exemptions," says Jones. "That's why people often have holding companies connected to an operating company. And if you have the ability to split income, there's usually a family trust structured in the mix as well."

An estate freeze—the process of freezing the value of your business now so future growth goes to your kids, not to you—is another effective tax-saving tool. Jones offers this example: Let's say you've accumulated $5 million worth of value in your business, and you want to keep working for another five or 10 years. Your kids work in the business, and you know you're eventually going to give it to them. If you freeze the value at $5 million so the capital gain of your estate is frozen at that level, the future growth accrues to the kids.

A further estate-planning tool would be to start paying yourself dividends each year by redeeming the frozen shares to reduce the $5 million gain that your estate would eventually pay tax on because you've transferred that gain to these new shares and it becomes taxable on death. Redeeming these shares each year as a deemed dividend instead of taking a salary will reduce this future gain and the tax paid by your estate.

"Everyone's situation is unique, and that's why you should get professional advice," says Oakey. "But it's never too soon to start thinking about succession planning. The day you start your business is the first time you should think about it."

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