Succession of a Family Business

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One of the side benefits of establishing an owner/managed business is the opportunity to pass the successful enterprise from one generation to the next. The establishment of a succession plan will go a long way toward the preservation of the business, facilitate its continued growth and minimize family disputes throughout the transition period.

The first step in the process entails an honest evaluation of the owner's aspirations for the business after his tenure is completed. In many cases it is hard for the business founder to take one step back and see his business being run in a manner that he might not have chosen if he were still at the helm. It is not easy to let go of the reins and take a backseat when corporate decisions are being made. It is difficult to give up daily control of the operations that he has assumed since the company's inception. For some, a transfer of ownership to a family member may be the "dream of a lifetime"; to others, just such a transfer could be a nightmare best avoided if at all possible.

The next step involves an evaluation of the children's individual strengths and weaknesses. Personal qualities such as maturity, business acumen, education, desire and intra-family relationships must all be considered. The founder must attempt to keep the transition as business-like as possible and separate "family" from "business" as much as possible.

The third step involves the structure of the business transfer. The business can be transferred by a number of methods including an outright gift of company shares, their sale or by an "estate freeze". Current income tax provisions allow owners of qualifying small businesses to shelter capital gains realized upon the sale of their shares through the $400,000 capital gains exemption, and this provision is effective in all arm's length sales, even inter-generational transfers.

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The gifting of corporate shares owned by the founder to his family member is considered to have been done at fair market value. The shares must be valued at what they are worth on the open market, and the founder will realize a capital gain on their transfer. Although there may be no need for cash as far as payment of taxes liable on the capital gain is concerned, the main problem with this type of transfer is it does not provide the founder with any funds for retirement and may not be viable unless the founder is truly "independently wealthy."

The sale of corporate shares is similar to gifting, but involves the transfer of funds between the parties. The sale price must be at fair market value and the founder will realize a taxable capital gain on the transaction. Once again the capital gain on the transfer will be sheltered, however in this case, the founder will receive proceeds that can be used in his retirement.

An estate freeze is a method that "freezes" the value of the business at a certain date and allows any future growth of the business to pass onto the next generation. This ensures that any future growth will not be taxed in the hands of the founder. Under this option, the founder gives up his common shares of the company in return for debt and preference shares of the corporation. The preference shares are set up in such a way that the founder can receive a fixed percentage dividend each year from the company and thereby continue to receive an income. These shares can also be set up in such a way as to be redeemable, in whole or in part, at the founder's discretion. This will allow him to cash out at any future date.

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