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How to Structure Your Business for Sale or Transition to the Next Generation

This article is not intended as legal advice. Professional advice should be sought prior to implementing any of the ideas conveyed in this article.

By Todd Louie

Entrepreneurs considering selling their business or passing their family business down to the next generation often overlook the implications of taxes at the time either event takes place.

Unlike the United States, Canada does not have estate taxes. However, we do have capital gains taxes that must be paid either when our businesses are sold or upon death.

Failure to properly structure your affairs well in advance of selling your business or, of death, can result in the need to pay hundreds of thousands, if not millions of dollars in capital gains taxes that may have otherwise been avoided through proper planning.

Many business owners are surprised to learn that selling a successful business or passing away can carry a tax cost of as much as 25% of the value of their company.

The following are frequently asked questions from business owners who realize they will eventually trigger a taxable event:

1) Can these taxes be avoided?
2) Is tax avoidance illegal?

The short answer to the questions above is yes, these taxes may be avoidable and no, tax avoidance is not illegal in Canada.

Some business owners mistakenly believe that tax avoidance is the same as tax evasion.

Tax evasion is a criminal offence; whereas tax avoidance is the right of every taxpayer who undertakes prudent and compliant tax planning strategies in order to reduce the amount of tax he or she would otherwise be expected to pay.

To best understand the law in Canada respecting tax avoidance, consider the very old court case in England involving payments made by the Duke of Westminster to his gardener.

The Duke was advised by a clever lawyer and his accountant that he could cause payments made to the gardener to become tax deductible by simply changing the frequency of payments.

The British tax authorities were not impressed and reassessed the Duke for a large amount of tax.

The matter went to the courts of England where a decision was rendered that now serves as the backdrop for the anti-avoidance rules in Canada. The following poetic words apply to every Canadian business owner concerned about the rightfulness of avoiding taxes through legitimate tax planning strategies:

"Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax-payers may be of his ingenuity, he cannot be compelled to pay an increased tax".

The expression above by Lord Tomlin of the English court provides sufficient encouragement for business owners to take advantage of tax planning opportunities that result in the avoidance of unnecessary tax.

How can unnecessary taxes be avoided when selling a business or when passing a business on to the next generation? One method of rightfully avoiding unnecessary taxes is an estate freeze.

This strategy has the effect of passing the future growth of your business to your children today without the need to pay capital gains tax on the future increased value of your company as it continues to grow in value.

Through estate freeze strategies, you can establish a family trust that can allow you to recognize family members as potential future shareholders without the need for you to lose control of your business.

A family trust can also allow you to give shares to family members in the future, when and if you should choose to do so. This structure allows you to make decisions down the road as life circumstances change.

Another important tax benefit in Canada is the Lifetime Capital Gains Exemption (LCGE). This important tax exemption is available on the shares of Qualified Small Business Corporations (QSBC's) as defined in the Income Tax Act (ITA).

The LCGE is $883,384 in 2020 and is indexed to increases each year. In some cases, the LCGE can be multiplied through the use of a family trust to include various family members resulting in no or little tax to pay down the road. Unfortunately, entitlement for the LCGE is not automatic. In order to qualify for the LCGE at the time of sale of death you must not keep excess surplus cash or investments within your corporation, or you can lose the LCGE.

The Bottom Line

If you have substantial amounts of unneeded cash or investments within your corporation, you may have to consider a strategy to remove the cash or investments from your corporation.

This strategy is called corporate purification and involves transferring excess cash or investments from your corporation to a sister company prior to a sale or in advance of death. Corporate purification strategies can be performed without tax and in combination with an estate freeze strategy and family trust to ensure you keep more of what you worked hard to build.

About the Author

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Todd has over 30 years of experience as a tax practitioner and is a Partner at Quantum Tax Law. Todd is well known across Canada as an educator in the tax community. He has lectured extensively to hundreds of accountants and lawyers in various jurisdictions across Canada.

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