

Business transition planning: Unleashing the tax opportunities!

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It's not surprising that Canadian small business owners spend most of their time focused on growing their businesses while often ignoring perhaps the most fundamental issue of all, that of transition planning. While many books, articles and seminars on this topic use the more common term "succession planning," this report will use the broader term "transition planning" because the owner is very much involved both in the actual transition and, in many cases, for years afterwards.

Transition planning, when done properly and in advance, can help set the stage for your business to be transitioned to the new owners, whether they are family members, key employees or a third party, and may help to reduce taxes. This report will attempt to highlight some of the key tax and estate planning opportunities in the context of a properly structured transition plan.

Transfer to family members

Perhaps the most obvious transition plan for a family business is to transfer it to the next generation. Whether or not this makes sense, however, will depend on whether the kids are already involved in the business and whether they have the maturity and expertise to take it over.

But what if one child is involved and the others are not? Or what if they all work in the business but you feel only one of them has the ability to successfully run it going forward? If you don't treat your kids equally with respect to equity in the business, what impact will that have on the future relationships you have with your kids and similarly, the relationships among the siblings?

All these questions can be addressed at the outset, with a documented transition plan. Perhaps the starting point, however, is to determine what is actually being transferred. That, of course, will depend on the legal structure of the business.

If the business is unincorporated, and is operating as a sole proprietorship or partnership, then you are simply transferring certain assets associated with that business, which can include both tangible assets, like furniture or equipment, and intangible assets, like customer lists or goodwill.

Since most small businesses of any significant size are structured as corporations, this report will focus mainly on the transfer or sale of the corporation's shares (although an asset sale is certainly possible — see below). When transferring the shares to the next generation, you have two options: a gift or a sale.

Gift of shares

Your first inclination may be to simply gift the shares of your business in equal portions to all your children, or perhaps, only to the children involved in the business. Of course, you would only contemplate doing this if you don't need the money from the potential sale of the shares to fund your personal lifestyle and retirement.

Making a gift, however, still has income tax consequences. You are deemed to have disposed of your shares for proceeds equal to their fair market value (FMV). That's why it's generally recommended to get a third party valuation prepared to substantiate the FMV since the Canada Revenue Agency (CRA) or Revenue Québec is especially likely to review the valuation, given there was no arm's length party on the other side of the share transfer to validate the FMV used.

The difference between the FMV and your adjusted cost base (ACB) or tax cost of your shares will be a capital gain, of which a portion is taxable at your marginal tax rate. Capital losses you may have realized on other property, either from the current or prior years, may be available to offset part of the capital gain realized on the gift. An estate freeze (discussed below) followed by a gift of the resulting preferred shares upon death can also be an effective way of gifting the shares and deferring the tax liability. It may also be possible to shelter some or all of the gain from the deemed disposition or estate freeze using the lifetime capital gains exemption for qualified small business corporation shares.

The lifetime capital gains exemption

The lifetime capital gains exemption (LCGE) may be available to shelter up to \$1,250,000¹ of capital gains on the sale of qualified small business corporation (QSBC) shares and qualified farm or fishing property.²

Simply stated, QSBC shares are shares of a Canadian-controlled private corporation in which "all or substantially all" (interpreted to mean 90% or more) of the value of the corporation's assets is used in an active business in Canada at the date of sale or transfer. In addition, either you or someone related to you must have owned the shares for at least two years prior to their disposition. Also, during that entire two-year period, more than 50% of the corporation's assets must have been used in an active business in Canada.

One of the most important steps in the transition plan, therefore, is to be vigilant to ensure that any investments made through your small business corporation do not inadvertently disqualify you from ultimately claiming the LCGE upon sale or, ultimately, upon death. (See below: Loss of the lifetime capital gains exemption.)

¹ Under proposals in the 2024 Federal budget, the LCGE increased to \$1,250,000 (from \$1,016,836) for dispositions as of June 25, 2024. The LCGE will be indexed to inflation after 2025. On January 31, 2025, the government announced that this proposal would be maintained, and the CRA will continue to administer this higher limit.

² Qualified farm or fishing property includes shares of a Canadian-controlled private corporation if more than 50% of the fair market value of the property owned by the corporation was attributable to property used principally in a farming or fishing business carried on in Canada.

That's why it's important for business owners to keep the operating company "pure." There are a number of ways to do this: some of them are simple, while others are more complex.

Simple strategies can include: regularly distributing non-active assets, using non-active assets to pay down debts, purchasing additional active business assets or paying a retiring allowance.

More complex strategies may involve paying tax-free inter-corporate dividends from the operating company (the active business) to a connected company³, thus purifying the operating company. The investing activities are then conducted through the connected company, which wouldn't qualify for the QSBC exemption anyway, thereby preserving the exemption for the operating company. A tax adviser should be consulted before implementing this strategy.

Owners worried about meeting the QSBC tests later on may wish to consider "crystallizing" the LCGE immediately through an estate freeze (see below: Loss of the lifetime capital gains exemption).

Another important step in the transition planning process is to ensure that the corporation's shares are properly structured in advance to permit multiple family members to access their own LCGE, assuming the potential gain on the gift of the shares is over \$1,250,000. For example, if the capital gain on the shares is \$2.5 million and you wish to transfer the business to your kids, ideally both you and your spouse or common-law partner, if applicable, would each individually already own 50% of the shares enabling each of you to claim the LCGE. If this is not currently the case, it may be worth reorganizing the share capital of your operating company to allow future access to multiple exemptions upon ultimate gift, sale or even death.

Loss of the lifetime capital gains exemption

The tax case of *The Estate of Edward Reilly v. The Queen* demonstrates how the lifetime capital gains exemption for QSBC shares can be forfeited by having too many investments inside an otherwise active small business corporation.

Edward Reilly died on March 13, 2000. At the time of his death, he owned a holding company which in turn owned an operating company, Reilly Ventures Limited ("Reilly"). Reilly owned and operated four family businesses: a Home Hardware franchised store, a plumbing business, a carwash and a laundromat.

When the executrix filed Mr. Reilly's terminal income tax return for the year of death, she claimed an LCGE of \$273,200, equal to the capital gain arising from the deemed disposition, at fair market value, of his shares.

The CRA reassessed and denied the exemption claim, arguing that the shares that were deemed to be disposed of upon death did not meet the definition of QSBC shares since Reilly corporation could not satisfy the 90% "all or substantially all test."

The CRA produced Reilly's balance sheet for the year ended May 31, 2000, just shortly after Mr. Reilly's death. The CRA concluded that since only 62% of Reilly's assets at the time of Reilly's death were actively used in the business, the corporation did not meet the test and therefore did not qualify for the QSBC exemption.

The estate argued that the cash and marketable securities were necessary "to permit a smooth transfer of the operating businesses from Mr. Reilly to the next generation."

The judge disagreed, finding that "there is no evidence that the cash and marketable securities held by [Reilly] were necessary or even important for the carrying on of its small active businesses."

The judge also reviewed the prior four years' balance sheets and determined the value of Reilly's cash and marketable securities, as a percentage of the book value of all the corporation's assets, was never less than 27%. As a result, the judge could not find that "all or substantially all of the fair market value of the assets of ("Reilly") was attributable to assets used principally in an active business."

³ Dividends may be recharacterized as a capital gain in certain circumstances.

Canadian Entrepreneurs' Incentive (CEI)

The 2024 Budget proposed the new CEI⁴, which would reduce the tax rate on capital gains on the disposition of qualifying shares. The CEI would reduce the capital gains inclusion rate to one-third, on up to \$2 million of capital gains over an individual's lifetime. The lifetime limit will be phased in by increments of \$200,000 per year, beginning on January 1, 2025, before ultimately reaching a value of \$2 million by January 1, 2034.

To qualify, the shares must meet certain conditions:

- At the time of sale, the shares were shares of a small business corporation
- Throughout the 24-month period immediately prior to sale, the shares were shares of a Canadian-Controlled Private Corporation of which more than 50% of the fair market value of the assets of the corporation were used principally in an active business carried on primarily in Canada by the CCPC
- The individual making the claim was a founding investor when the corporation was initially capitalized, and held the shares for a minimum of 5 years prior to sale
- At all times since the initial share subscription until the time of sale, the individual directly owned at least 10% of the fair market value of the shares and had 10% minimum voting rights
- Throughout the 5-year period immediately prior to sale, the individual must have been actively engaged on a "regular, continuous, and substantial basis" in the operations of the company

There are restrictions such that the CEI won't apply to shares of a professional corporation, nor to a corporation whose principal business is in the financial, insurance, real estate, food and accommodation, arts, recreation, or entertainment sectors, nor the consulting or personal care service industries.

Alternative Minimum Tax (AMT)

The Alternative Minimum Tax (AMT) system imposes a minimum level of tax on taxpayers who claim certain tax deductions, exemptions or credits to reduce the tax that they owe to very low levels. Under the AMT system, there is a parallel tax calculation that allows fewer deductions, exemptions, and credits than under the regular income tax calculation. If the amount of tax calculated under the AMT system is more than the amount of tax owing under the regular tax system, the difference owing is payable as AMT for the year.

Having large capital gains, particularly when you claim deductions (such as the LCGE or CEI), may give rise to AMT. More information is available in the CIBC report [Alternative Minimum Tax](#).

Sale of shares

In most family transition plans, rather than an outright gift of the shares, it is more likely that the business will be sold to the next generation since the proceeds from the sale represent a lifetime of wealth accumulation for the owner manager who generally needs those funds to live on after retiring from the business.

From a tax perspective, you have to be careful when structuring a sale to a family member, such as your child, since you will be deemed to receive proceeds equal to the FMV of the shares sold, no matter what price you assign to the shares. In other words, while you may be tempted to give your kids a "good deal" on the shares, you may find that such a gift can actually result in double taxation. How?

The *Income Tax Act* states that when property, such as shares, is sold to a non-arm's length party, the vendor is deemed to receive proceeds equal to the FMV but the purchaser's new ACB for the purpose of computing their own capital gain on ultimate disposition or death, is only deemed to be the amount paid.

⁴ The proposed CEI has not been enacted. On January 31, 2025, the government announced that this proposal would be maintained.

For example, let's say your business was worth \$3 million and you decide to "sell" it to your son for only \$1 million. For tax purposes, assuming you had a negligible ACB, you will be deemed to have sold the shares for the FMV of \$3 million and thus be taxable on the resultant \$3 million capital gain.

Your son, however, would only have a tax cost or ACB of \$1 million, equal to the amount he actually paid. If he should sell the shares even a day later to a third party, and realize \$3 million of proceeds (the shares' true FMV), he will also end up paying tax on a \$2 million capital gain. Alas, double taxation!

As with an outright gift, the CRA very likely may take a look at a sale transaction between related parties to ensure that it was done at FMV. That's why it's important to include a "price adjustment clause" in the contract of purchase and sale. This clause basically states that should the CRA or Revenue Québec challenge the sale price of the shares and value them at a higher amount than what was used in the purchase/sale agreement, then, upon unanimous consent, the price of the sale can be adjusted upwards retroactively.

Finally, the LCGE discussed above may also be available to shelter all or a portion of the capital gain realized upon sale from tax.

Proceeds in cash or debt

Once the FMV price of the shares has been established, the next question is how you will be paid: cash or debt.

Naturally, if the successor has the cash to pay, this is ideal as not only will it allow you to invest that cash to fund your retirement, but it can also allow you to distribute, either now or later, some of the cash to children or other family members who may not be participating in the business transition.

But debt may also be a handy tax deferral mechanism. If you take back debt, perhaps in the form of a promissory note, you have the ability to defer paying tax on the capital gain realized upon the sale of the shares immediately and recognize it over up to five years. If the sale is made to your child or grandchild (or their spouse or common-law partner), then you can recognize the gain over ten years. This is known as the "capital gains reserve."

For example, let's say you realized a \$1 million capital gain on the sale of your shares to your daughter and you structured a promissory note payable to you, with 10% (the maximum annual percentage deferral allowable under the *Income Tax Act*) due each year. That would allow you to report only \$100,000 of the capital gain in the year of sale and another \$100,000 each year for the next nine years.

Another factor to consider, however, is whether you want to still be involved in the business and participate in, or even control, major decisions going forward. In addition, perhaps you would still like to receive some annual cash flow from the business. Both of these goals can be accomplished through a shareholder's agreement (discussed below) or an "estate freeze."

Estate freeze

An estate freeze is a corporate transaction that allows you to essentially "freeze" the value of your ownership in the corporation, and have the future growth in the value of the company accrue to someone else, like your kids, who will ultimately control the business. The result is that the tax liability of the owner can be fixed at today's fair market value, and the tax liability on any future growth may be transferred to the new owners (such as family members), subject to special tax rules for CCPCs (discussed below).

A freeze, which can be done on a tax-deferred basis, is often accomplished by exchanging the common shares of the corporation for new fixed-value preferred shares, which are redeemable at the current fair market value of the corporation. New common shares are then issued to whoever may one day take over the company. In the case of continuing family involvement in the business, new common shares can be issued to the kids either directly or through an inter-vivos family trust, which may provide flexibility for future planning.

The new fixed-value preferred shares, referred to as the “freeze shares,” that have been issued to you can have voting rights. This allows you to maintain control of the company, while not necessarily continuing to be involved in the daily operations of the business. Running the company can be left to the kids, if they are the ones who now own the new common shares to which the future increase in value of the business will accrue.

The shares can also have a preferential stated dividend rate, allowing you to receive an annual income from the company while the shares are outstanding.

If the value of your company is depressed, perhaps due to economic conditions, doing a freeze when your company's value is lower may permit you to significantly reduce your estate's tax exposure at death, assuming the value of the shares ultimately appreciates again. You must, however, ensure that the value associated with your freeze shares today will be sufficient to support your future needs.

But what if you've already implemented an estate freeze when your company value was higher? In that case, you may wish to consider a “refreeze.” For example, if you froze the company when the value was \$5 million, and today the company is worth only \$3 million, you would refreeze by exchanging your old \$5-million redeemable preferred shares for new preferred shares redeemable at \$3 million (assuming you are comfortable with this reduced entitlement). Note that a shareholder benefit may arise with a refreeze, so care should be taken with this strategy. Should market conditions recover and the business go back up in value, any future gain can be taxed in the common shareholders' hands instead of yours (or your estate's).

Special tax rules for CCPCs

The Tax On Split Income (TOSI) rules generally apply where an adult receives dividend or interest income from a private corporation, or realizes a capital gain, and a related individual is either actively engaged in the business of the corporation or holds a significant amount of equity (with at least 10% of the value) in the corporation. When TOSI applies, interest, dividends and capital gains received from private company shares by the adult family member may be taxed to the adult at the highest marginal tax rate. Although there are a number of important exceptions that may prevent the rules from applying, the TOSI rules should be considered before entering into an estate freeze or if family members hold shares of a private corporation.

More information on the tax rules for CCPCs is available in the CIBC report [The CCPC tax rules](#). You should discuss these rules with your legal and tax advisers.

Sale to employees

While many of the tax planning concepts discussed above are also relevant when the transition plan involves non-family members, such as key employees, there are a few additional opportunities that should be examined when dealing with transition plans.

In fact, it may come as a surprise to you, but generally speaking, businesses that are transferred through a “management buyout” (MBO) to non-family members are generally more successful going forward than businesses in which family members or even an arm's length third party is the successor. That's because the existing management team is intimately familiar with the business, the industry and its suppliers and customers, which can allow the business to continue to run its daily operations smoothly with minimal interruptions.

It's critical, however, to involve management early in the transition process to make sure that they truly want an equity stake as they may be content to simply manage and run the business, as opposed to having the risk associated with entrepreneurial ownership.

Financing the MBO

Perhaps the biggest impediment to the MBO is financing. How the employees who are going to take over the business are going to pay for it is crucial as, chances are, they simply don't have the current financial resources to finance it with upfront cash.

Debt financing is often used by employees in this scenario, referred to as a “leveraged buyout” (LBO). In an LBO, typically the employees who are buying the operating company from the original owner or owners would form a new corporation that will be used to purchase the shares.

This new employee-owned company would get third party financing and use the proceeds from that financing to purchase the shares in the operating company. Then, both companies would be amalgamated allowing the interest paid on the debt borrowed to be tax deductible against the future earnings from operations. This is essentially a “self-funding” structure as it’s the future profitability of the operations that will both service the debt (that is, pay the interest) and pay it down over time (that is, pay the principal).

With an LBO, it’s common that the lending institution will want an equity component to be comfortable with the financing. That equity can either come from management or from a third-party private equity investor.

Provided the employees are not related to the owner, you may still use the LCGE (discussed above) to exempt part or all of the resultant capital gain from tax.

Employee Ownership Trusts

An employee ownership trust (EOT) is a form of employee ownership where a trust holds shares of a corporation for the benefit of the corporation’s employees. EOTs can be used to facilitate the purchase of a business by its employees, without requiring them to directly pay to acquire shares. For business owners, an EOT provides an additional option for succession planning.

A temporary exemption is available so that there would be no tax on the first \$10 million in capital gains realized on the sale of a shares of a qualifying corporation to an EOT in 2024, 2025 and 2026, subject to certain conditions. This \$10 million exemption applies to the business, and not to each shareholder. This means that if multiple individuals dispose of shares to an EOT as part of a qualifying business transfer and meet the qualifying conditions, they may each claim the exemption, but the total exemption claimed can’t exceed \$10 million in aggregate. The individuals will be required to agree on how to allocate the exemption.

You may also be able to claim a capital gains reserve if you sell shares to an EOT and will receive some of the proceeds in future years. The reserve effectively allows you to bring any taxable capital gains into your income in equal amounts over up to 10 years (in most other cases, the reserve period is limited to only 5 years).

Sale to third party

The final option for transition, and often the most common assuming family members won’t be taking over and there aren’t any key employees that are either interested or capable of taking over the business, is to sell to a third party.

A third party sale can involve selling to a supplier, a competitor, a customer, an entirely unrelated third-party or even going public. Often competitors are extremely attractive suitors as not only will it allow them to grow their own business but it also eliminates an obvious competitor!

The search for the right purchaser, however, can be a challenge and it’s best to bring in other professionals with experience in this area to assist in the process. For example, an investment banker who specializes in the buying and selling of small- and medium-sized private companies can be of huge assistance in helping you not only achieve the highest possible selling price but in structuring the deal to maximize your tax efficiency, while maintaining confidentiality and providing for minimal disruption to the ongoing business.

An investment banker would work with you to develop a thorough and strategic understanding of the business and your needs, identify and qualify both industry buyers and private equity buyers in North America and around the world, and conduct market and financial analysis to determine the potential strategic value to different buyers.

Finally, your investment banker would prepare marketing materials to accurately communicate the nature of the business and position it as an attractive acquisition opportunity, approach an agreed upon list of buyers with these materials to determine their level of interest and ultimately, receive bids and negotiate and structure the transaction with a chosen buyer. They can work with your professional advisors who provide the advice on tax and legal issues.

The tax issues associated with sale of shares to a third-party are very similar to those in connection with a sale to family member. If the third party is a public company, you may receive part of your proceeds in shares of the purchaser. While this can often be done on a tax-deferred basis, you ultimately end up swapping shares in a company you do control with shares in a company you don't control, often with conditions around when you can sell your shares.

Sale of assets

When dealing with a third-party purchaser, there is also the possibility that the purchaser may be interested in purchasing the assets of the corporation rather than the shares. Let's review the tax aspects of an asset sale.

From a tax point of view, the main planning opportunity, and the object of much discussion between the vendor and purchaser, is how the purchase price of the assets will be allocated among the assets being sold in a way that minimizes the tax liability.

As a general rule, the vendor would like to allocate the purchase price to assets that, when sold, give rise to capital gain (for example, land) while the purchaser will try to assign the purchase price to depreciable assets that can be fully written off in future years. There may also be non-income tax considerations to the purchaser, such as land transfer tax, Goods and Services Tax / Harmonized Sales Tax (GST / HST) or provincial sales taxes, which generally don't apply when the transition involves a share sale.

Eligible Capital Property (ECP)

Presumably the business being sold is worth more than merely the value of its underlying tangible assets, such as buildings, inventory and equipment. The excess of the purchase price over the FMV attributed to the hard assets is referred to as "goodwill." ECP is treated as a class of depreciable capital property.

If this type of property is sold, one disadvantage is that there may be a capital gain or loss. This may limit your opportunity to defer tax by retaining sale proceeds in a corporation, since capital gains are generally taxed at higher corporate tax rate than business income that is eligible for the small business deduction.

On the plus side, you may be able to claim a capital gains reserve if sale proceeds are received over a number of years. Also, the corporation can continue to have the opportunity to pay capital dividends, which are generally received tax-free by shareholders.

Role of life insurance

Often life insurance can play a key role in transition planning, especially if there is a liquidity event (that is, an event that may trigger an immediate need for cash such as funding a potential tax liability upon death).

Shareholders' agreement

Life insurance is also helpful when trying to strategically arrange funding under a shareholders' agreement. A shareholders' agreement can be a critical planning tool if you share ownership of your private company. These agreements typically list the various rights and obligations of the shareholders to each other. They also provide for what happens to the shares of a particular shareholder when that person wants to sell their shares, becomes disabled or even dies.

The ability to use the tax-free death benefit associated with a life-insurance policy can provide an effective way to "buy out" a deceased shareholder's shares upon death provided the corporation is the designated beneficiary of the policy. It's important, however, that the agreement defines "value" as not including the value of the life insurance. In addition, shareholder agreements are often designed to allow a selling shareholder to use part or all of the LCGE and CEI on the disposition of qualifying shares, as discussed above, provided that the corporation still qualifies if it owns the life insurance policy itself.

It's critical, however, for shareholders' agreements to contemplate what happens on death. If they're silent, the wishes of a deceased shareholder could end up in court. (See below: Shareholders' agreements - Case study.)

Shareholders' agreements – Case study

A case from Ontario involved Cheryl Sylvestre and Jack, Donny, Bing and Cam Frye, the five children of George Frye, who died in 1991, leaving the shares of his private company to his children equally.

The five siblings signed a shareholders' agreement in 1991 (confirmed by a second agreement in 1994), which declared their intention was to preserve the company as a family business, and for all of the children to share equally in it. The shareholders' agreement contained a clause that required any sibling who wanted to sell their shares to first offer them to the company. If the company didn't want the shares, they would then be made available to individual siblings on a pro rata basis. The agreement further stated that the shares could only be sold to a third party after the first two offers were declined.

According to court documents, the Fries "feuded constantly over the years over control of the business." In 1994, Bing sold all of his shares back to the company, which left his siblings owning 25% each. When Cam died in April 2002, he left all of his shares to his sister Cheryl. Jack sued, arguing, among other things, that the shareholders' agreement prohibited Cam from transferring his shares to Cheryl through his will. While the trial judge found the gift to be "null and void," this was overturned upon appeal, as the Appeal Court concluded that the agreement could not prevent Cam from leaving his shares to whomever he wanted in his will. Had the Fries' shareholders' agreement specifically dealt with the inevitability of death, perhaps there would have been a different, less fractious outcome.

Who will own the insurance?

If you operate your business through a corporation, an important question is whether life insurance should be held personally or by the corporation. From a tax point of view, it may be possible for an absolute savings to be realized if life-insurance premiums are paid for by the corporation. That's because, generally speaking, life-insurance premiums are not tax-deductible. (Life insurance is only deductible where the insurance is required as collateral for a loan, assuming certain very specific criteria are met.)

When the insurance policy is owned by a corporation, premiums are paid from corporate funds that have only been subject to tax at the corporate level. The corporate tax rate is generally lower than the personal tax rate meaning that taxes may be reduced by using "cheaper" corporate dollars to pay non-deductible expenses.

To illustrate this point, let's assume that Darren is a business owner in Ontario and pays tax at the top personal tax rates. Darren has a life-insurance policy to provide for his family in the case that he dies prematurely. His annual premiums total \$1,000.

If Darren were to pay the life-insurance premiums personally and his income is taxed at a personal rate of 53.5%, he would have to earn \$2,150 [$\$1,000 \div (1 - 0.535)$] personally in order to be able to pay the \$1,000 insurance premium and would be left with no cash.

If, on the other hand, Darren's company owned the life insurance policy, it would pay the \$1,000 insurance premium, which is assumed not to be tax-deductible, as discussed above. If Darren's company is a Canadian-controlled private corporation (CCPC), it can take advantage of the small-business deduction on its first \$500,000 of active business income to lessen his after-tax cost of the insurance premiums. Suppose the corporation earned the same \$2,150 of business income. After paying corporate tax and distributing after-tax income as dividends to Darren, who would pay personal tax, Darren would be left with \$464 more cash than if he paid the insurance premiums personally because Darren is effectively using cheaper after-tax dollars in the corporation to pay the non-deductible insurance premiums.⁵

In this example, the corporation would own the policy and receive the death benefit. This death benefit can generally be paid out of the corporation to its shareholders, either mostly, or in many cases, entirely tax-free, as a special dividend, known as a "capital dividend." Whether the entire death benefit can be paid to the shareholder free of tax depends on how much of that death benefit can be allocated to the corporation's capital dividend account (CDA). The insurance policy death benefit, less the adjusted cost base (ACB) of the policy, can be added to the CDA. A positive balance in the CDA can be paid out as a tax-free capital dividend.

⁵ After paying corporate tax of \$262 ($\$2,150 \times 12.2\%$) and the \$1,000 insurance premium, there would be \$888 ($\$2,150 - \$262 - \$1,000$) for distribution as dividends. Darren would pay tax of \$424 ($\$888 \times 47.7\%$) on the dividend, leaving cash of \$464 ($\$888 - \424), compared to no cash if Darren paid the insurance premium personally.

Conclusion

This article only provides a brief overview of some of the key elements involved with transition planning.⁶ You should speak with your tax and legal advisors for additional considerations regarding planning for the transition of your private company.

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⁶ For more information, here are three Canadian-based publications that were used in researching this report and that may be used to delve deeper into aspects of transition planning:

- David Malach and Stuart Bollefer, "The Business in Transition – Making the Succession Plan Work," LexisNexis, 2008
- Ian Hull, "Advising Families on Succession Planning: The High Price of Not Talking" LexisNexis, 2005
- Luanna McGowan, Corina Weigl and David Wilton, "Succession Planning Toolkit for Business Owners: Leveraging Your Life's Work" by CPA Canada, 2006

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