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Case Study

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The tax wake-up call – and why it's never too early for business families to plan ahead

In August 2020, Jim Reid got a phone call from his sister Nancy that he would never forget.

"Jeanie just called – Michael died at the cottage this morning. They think it was a heart attack, he just fell to the ground."

Michael was Jim's younger brother. Jim, Michael and their sister Nancy were co-owners of the family lumber business, JMN Reid Lumber Inc. their dad had started in 1966. The three Reid siblings had taken over the business in the 1980s and expanded it significantly.

Jim was 73, Nancy was 72 and Michael was the youngest at age 70. Michael was also an avid runner, which made his death even more shocking on that August morning.

The Reid family had always been tightly knit. Together, they'd navigated some tough business decisions over the years. In addition, all three of the sibling owners had one or more of their adult children involved in the business.

There was no plan to facilitate a buyout and Jeanie (Michael's wife) inherited his shares. She had been a tremendous addition to their family and Jim and Nancy had no concerns about their new business partner. In the months that followed, the hardest part was just pushing through their shock and grief to carry on. Somehow, with the help of a good management team, they managed to do it.

Our latest case study highlights a significant issue faced by many successful business families. Names and other key identifiers have been changed for privacy reasons, but the situation and key issues presented here are real.

THE WAKEUP CALL

As Michael's estate moved through the settlement process, their lawyers alerted the owners to another shock. Michael's estate rolled over his company shares to his spouse Jeanie on a tax-deferred basis. But the lawyers noted that the potential tax liability – had this rollover not been available – was huge. Were Jeanie to die tomorrow, her estate is valued at $200 million which would result in a $50 million tax liability in estate taxes – on the shares alone.

Jim and his siblings hadn't made specific plans to address tax issues on death. They had assumed the issue was far in the future given the longevity of their parents. Both were still alive in their late 90s. Their hope was that once they'd completed their cross-country business expansion, the business would generate the cash needed to cover any tax liabilities. But with the staggering tax amount that could have been due upon Michael's death, it was clear they'd greatly underestimated the looming tax liability for each of them.

So now what?

Jim realized there were several problems with their previous plan.

1

DEATH HAD OCCURRED EARLIER THAN EXPECTED.

Ideally, Jim and his siblings would have planned to "expect the unexpected." They had dodged a tax bullet due to the rollover of shares, but he realized just how vulnerable they truly were. They had leveraged the business due to the expansion. And they had little liquidity if it were needed in the event of another death.

2

THEIR BUSINESS WAS STILL GROWING, ALONG WITH THE TAX LIABILITY.

The owners expected that the business expansion would lead to greater profits and liquidity. What they didn't consider is the long term tax implications as the business grew. The tax liability was already much more than expected. And it would be much greater in 10 years time. The bottom line? As the Reids' business was growing, so was its tax liability.

3

PUTTING OFF ACTION WOULD JEOPARDIZE THE BUSINESS FOR YOUNGER FAMILY MEMBERS.

If the current owners needed money to cover taxes soon, they'd have to sell company assets, and the next generation would be the ones feeling this impact. There were currently six adult children of the current owners involved in the business. Any strategy needed to address this future generation of owners as well. For Jim and his family, it would make sense to coordinate their tax strategy together as oppose to each shareholder having their own individual plan. The source of the family's funds will come from JMN Reid Lumber – which ultimately triggers the tax value of the corporation and its funds will be used to pay the tax.

FINDING A SOLUTION IN AN UNEXPECTED WAY

The ownership's collective lack of tax planning worried Jim. He realized that a single unfortunate death could cause a material continuity problem for a business that had lasted three generations.

Jim recalled his father's favourite saying: "The best time to plant a tree is 20 years ago. The next best time is today – right now." They had missed that "20 years ago" opportunity for optimum tax planning. But Jim was certain there were actions they could take right now that would help. On behalf of the other two owners, he undertook to find out.

Jim consulted an advisor who specialized in strategies available to fund large tax liabilities. The advisor set out some different funding options. It included one that Jim had not considered – the use of permanent life insurance.

Jim was sceptical about the insurance – it seemed like another sales pitch. At their ages, he didn’t see how insurance made sense. The premium costs would be through the roof. In addition, with the three shareholders now in their 70s, it wasn’t clear whether any of them would qualify for coverage. Wasn’t it “too late in the game?”

Jim and the advisor went back and forth on different scenarios over the next few months. The advisor also took the lead in accessing the expertise of JMN Reid Lumber’s lawyers and accountants. It was ultimately Jim’s own accountant who suggested he take another look at the insurance option. With the help of the advisor, the accountant had run the numbers. It was clear that permanent life insurance could indeed fund a future tax liability at a much lower ongoing cost in most cases.

With his accountant’s recommendation, Jim asked the advisor to take the shareholders through the life insurance application process. This would settle the question about affordability and the viability of coverage.

When the life insurance application and medical/financial underwriting was completed, the advisor and the company’s other professional advisors presented Jim with their proposed solution.

The Bottom Line

Jim was proud of how he and his siblings had grown the business. However, Michael’s death made him realize what he should have paid attention to in the last 20 years:

- **Prepare the next generation by making it a priority to accelerate their training and take on a active role, so they’d be prepared to take the reins and deal with ownership issues.**
- **To have a contingency plan, if the unexpected occurred.**
- **Ensure to track the tax liabilities as the family continues to plan going forward.**
- **And, it's never to *early* to start planning.**

Jim now had a solid plan to cover future estate tax liabilities – and help ensure business continuity for the next generation. While the tax liability issue had been a challenging problem, it was also a solvable one in the end as they were able to still "plant a tree."

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