Pearlstein's Corner

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Adequate Liquidity Can Mean the Difference between a Successful and Failed Business Succession. Do You Have a Plan in Place?

Over the next five to ten years in Canada well over $1-trillion in small business assets will be transitioned or sold to family, management or a third party. Succession planning is simply a roadmap for the transfer of ownership and leadership of your business. However, what some owners fail to realize is that financing the ownership change can often present the biggest obstacle to a successful outcome for both owners and successors.

Specifically, having the liquidity in place to pay capital gains tax is a key consideration. According to a recent Business Development Bank survey, two in five owners who plan to sell have done little to improve their financial reporting.

This includes forward planning so the funds are available to implement the transition on the best possible terms. Here is what you need to prepare.

Liquidity is needed to Pay Up to 27% Capital Gains Tax

Liquidity means either cash or assets you can easily and quickly turn into cash. In this context, it's important because most business owners are fully invested in their businesses and, at some point, a big tax bill is coming.

When it's time to transition or sell your business, for every $100 of fair market value sold, you will owe up to $27 in capital gains tax, less your original cost.

You can't avoid paying this tax, but there are ways to reduce the bill. The question is - do you have a way to pay the capital gains tax if you sold your business today?

The Difference between Transitioning and Selling Your Business

There are three main options to sell your business. About one-third of business owners plan on having family members take over. The rest consider selling to existing management or to a third party.

But in many cases, "the plan" is just a thought with little real planning behind it.

The grim reality is that due to lack of planning, 75% of businesses don't make it past the first generation. They don't sell, they don't transition successfully, they simply close up and disappear.

For those considering transitioning to family, it may mean you are gifting or selling, which often results in receiving less than fair market value right away, and many owners are fine with that. It's the cost of keeping it in the family. Historically, selling to a third party gives the owner a better chance of achieving true value.

Still, whether it's an internal transition or an external sale, you need at least three to five years to prepare. By not giving yourself enough time, you can end up making decisions that can put your business at risk and leave money on the table, or worse yet, a completely failed transition. And, of course, at some point the tax bill will be due and needs to be dealt with.

How to Value Your Business

Valuation is not an exact science. There are different ways of achieving a valuation. Each method is based on specific assumptions and financial information, which typically result in different values.

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Investors generally prefer valuing a business based on discounted cash flows which answers three important questions:

• **Value**: How much is the business worth today based on future earnings?

• **Rate of Return**: What is the buyer's expected rate of return, given the amount invested and your financial projections?

• **Equity Share**: How much equity will the buyer receive for their investment?

A professional business valuator should be engaged to determine the value of your business, offer an objective view of your business's worth and give investors confidence in the valuation.

Creating Liquidity

There are a number of options for creating liquidity to cover a future tax liability. As your business grows and matures, you may be in a position to manage your operating cash flows more efficiently and build a tax reserve consisting of liquid investments outside of your operating assets.

Or, with proper planning, you can reduce the 27% capital gains tax by using CRA rules that allow a lifetime capital gains exemption of $850,000 per shareholder.

Another option is to access lines of credit from a bank.

An Example of Thinking from the End to Prepare for Capital Gains Tax

I have clients who have all of their assets in commercial income properties. If they both died – a joint unexpected tragedy – before we started planning, their tax bill tomorrow would have been $10-million, or 27% of their net worth. Neither their adult children nor their estate had the cash available to pay, which could have resulted in a fire sale of some of their properties.

This was not an option they wanted. A fire sale means generally accepting less than market value, and, in this case, they were passionate about their properties and their business, and didn't want to sell any of it. Their goal was to leave a lasting legacy for their children.

They also were adamant about not borrowing because of a bank foreclosure scare many years before.

Thinking about death and taxes may be unpleasant for most, but the reality is that this is where we had to begin. In fact, part of thinking through their tax bill was to first determine their business's worth.

My clients' tax professionals provided the required business valuation information. After we felt comfortable with the valuation and the potential tax bill owing, we needed to come up with options to create liquidity.

Here is what I did, based on their situation.

The solution included using some current cash flow from the business to invest in a whole life insurance policy with an immediate death benefit of $10-million.

Over time this type of insurance – permanent or whole life – grows in a tax deferred environment. So, the death benefit would potentially grow to more than $10-million as dividends from the insurance policy get reinvested on the investment side of the policy. Because the insurance is held in the corporation, most of the death benefit is paid out through its capital dividend account – tax free.

My clients' cash flow easily paid the premiums and they were comfortable that their children would be able to take over the business without having to sell properties.

In Summary, You Need to Start Planning Now

No matter what your succession tax bill comes to, the point is that solutions for creating liquidity are flexible and scalable.

Whether you are transitioning or selling your successful business, at some point you will end up paying a hefty bill in capital gains tax on up to 27% of the fair market value of your business, less its original cost.

There are a number of ways to reduce that tax and prepare for it by creating liquidity. You also need to think from the end by planning for an unexpected tragedy. Finally, you need at least three to five years to create a plan and put it into place. The time to start is now.

Do you know someone who should read this?

Some of my clients have mentioned that they've shared my newsletters with other family members, friends or colleagues. If you know someone who might benefit from this, why not pass it on?

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