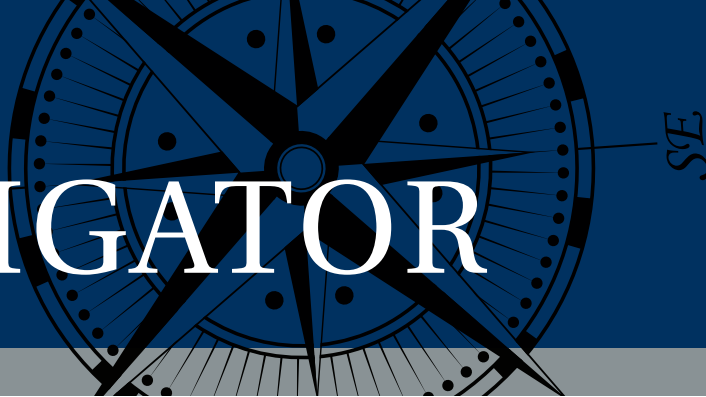


THE NAVIGATOR



SALE OF YOUR BUSINESS – PART 1

Running an active business with no immediate plans to sell

The content of this article is for information purposes only and does not provide tax or legal advice. It is imperative that you obtain professional advice from a qualified tax and legal advisor before acting on any of the information in this article. This will ensure that your own circumstances are properly considered and that action is taken based on the most current legislation.

A study done by the Canadian Federation of Independent Business (CFIB) revealed that 70% of small and medium-sized business owners intend to exit their businesses within 10 years. The most common method among owners of exiting their businesses is to sell outright to non-family members (37%).

The first in a four-part series, this article introduces some tax planning strategies to consider when you are operating your business as a going concern and have no immediate plans to sell. This four-part series takes you through some of the key issues and tax planning strategies to consider during the various stages of your business:

Part 1: Running an active business with no immediate plans to sell

Part 2: Planning to sell your business or impending sale

Part 3: Year of sale of your business

Part 4: Year after the sale of your business

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC). This means that the corporation is not controlled by a non-resident of Canada or a public corporation and no class of shares of the corporation is listed on a prescribed stock exchange. This four part series does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.



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WHAT IS YOUR CORPORATE STRUCTURE?

If your corporate structure looks like Figure 1, where you are 100% owner of your operating company (Opco) or 100% owner of a holding company (Holdco) that owns 100% of your Opco this may not be the most tax efficient structure. This type of structure would not easily allow for the multiplication of the \$750,000 (proposed to increase to \$800,000 for dispositions after 2013) capital gains exemption (CGE) with other family members on the sale of the shares of your qualifying small business corporation (QSBC). If we assume you are in the highest tax bracket, being able to multiply the CGE would result in federal tax savings of \$108,750 ($\$750,000 \times 50\% \times 29\%$) per family member. For example, let's assume that the total capital gain on the sale of your qualifying business is \$1,500,000. If you owned 100% of the shares then you would only be able to shelter \$750,000 of the capital gain by claiming a capital gains exemption. Assuming you are at the

top tax bracket, your total federal tax on the capital gain would be \$108,750 ($1,500,000 \text{ capital gain} - 750,000 \text{ capital gains exemption} = 750,000 \text{ unsheltered capital gain} \times 50\% = \text{taxable capital gain of } 375,000 \times 29\% \text{ federal tax rate} = 108,750$). However, if instead you and one other family member owned the shares being sold then each of you can claim \$750,000 capital gains exemption sheltering \$1,500,000 instead of only \$750,000 resulting in tax savings of \$108,750. The tax savings is higher when provincial tax savings are considered.

CONSIDER A MORE FLEXIBLE STRUCTURE ("ESTATE FREEZE")

If your corporate structure looks like one of the two pictures in Figure 1, you may want to consider reorganizing your corporation so that your spouse and/or children and grandchildren (or any other family member you desire) own shares of your corporation, either directly or indirectly through a discretionary family trust. The step-by-step procedures to implement

this structure are beyond the scope of this article however the major components are briefly mentioned.

This structure is usually achieved by doing an estate freeze where you would exchange the shares you currently own for fixed value preferred shares and issue new common shares, either directly or indirectly

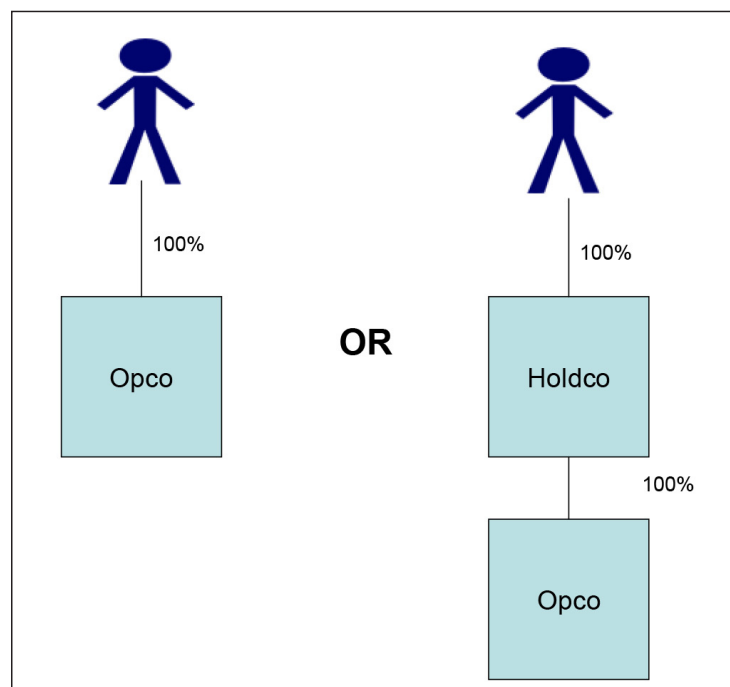
through a discretionary family trust, to other family members. The use of a family trust may allow for more flexibility in terms of tax planning and increased control. A family trust may be necessary if minors are involved. In addition you may want to include a Holdco as a beneficiary of the family trust. Having a Holdco as part of the structure allows you to keep your operating business onside with the QSBC rules by paying out excess assets to the Holdco. This structure may also provide better creditor protection however you should speak to your legal advisor about the extent of creditor protection provided in the structure illustrated in Figure 2.

ONGOING PURIFICATION TECHNIQUES

There are a number of structures possible to implement an estate freeze. The following is one alternative that allows for ongoing purification using a trust with a corporate beneficiary. Here are the possible steps to implement this structure:

1. Mrs. A establishes Holdco and subscribes for super voting special shares to control the company.
2. A Family Trust is settled and the Trust subscribes for the common shares of Holdco. Holdco is also named as one of the beneficiaries of the Family Trust.
3. Mrs. A exchanges her common shares of Opco for preferred shares worth \$750,000, non-voting preferred shares for the balance of the current value of Opco and nominal special voting shares.
4. The Family Trust subscribes for non-voting common shares of Opco.
5. When Opco generates passive assets that are not needed by the business, dividends can be paid on the common shares held by the Family Trust. The dividends can then be

Figure 1



allocated by the Trust to either the family members or Holdco (or both).

6. Dividends allocated to the family member beneficiaries will be taxed in their hands at their marginal tax rates. Dividends allocated to Holdco will be considered a tax-free inter-corporate dividend from a connected corporation.

TAX STRATEGIES TO CONSIDER AT THIS STAGE OF YOUR BUSINESS

1. The \$750,000 CGE available on the disposition of QSBC shares can be multiplied if you and your family members own shares of your corporation, directly or indirectly. The definition of QSBC shares is beyond the scope of this article but is discussed in another article “Capital Gains Exemption on Private Shares”. Ask your RBC advisor for a copy. If you need further information please contact your qualified tax advisor. Each individual shareholder is entitled to claim a \$750,000 CGE during their lifetime. Instead of only being able to claim one \$750,000 CGE, a family of four can claim \$3 million, resulting in an additional tax saving of \$562,500 (assuming a federal and provincial marginal tax rate of 50.00%). The structure in Figure 2 puts you in a better position to multiply the \$750,000 CGE in the future with other family members. Each beneficiary of the trust that is an individual can claim a \$750,000 CGE when the shares of your qualifying business are sold. It is important to note that for your family members to qualify for the CGE, the trust in Figure 2 must be holding the shares for at least 24 months before the sale. You would not be able to set this structure up immediately before a sale to multiply the CGE because of this 24-month holding period test. This is why

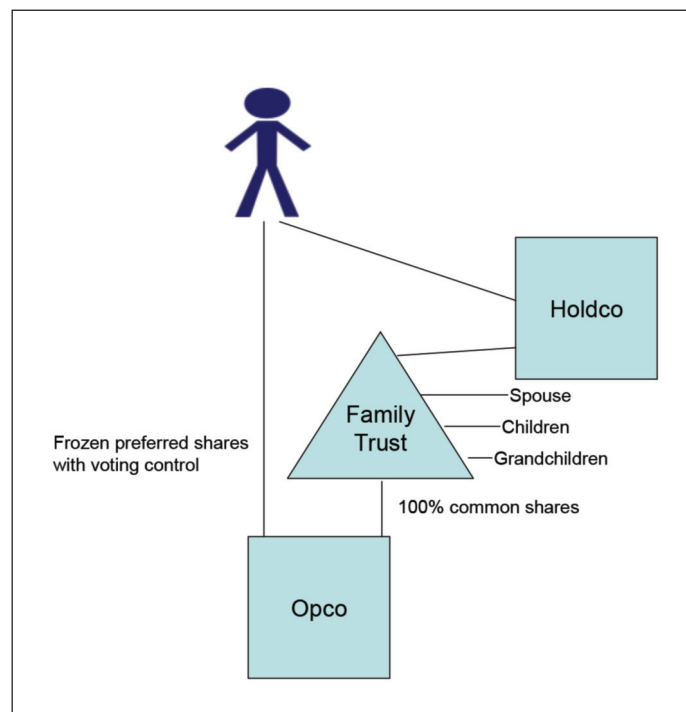
implementing this structure at this stage is important. In addition, the value of the business must increase after the estate freeze to allow the beneficiaries’ interest to grow so that they can take advantage of their CGE.

Because of the 21-year deemed disposition rule for trusts, you may not want to implement this strategy too early if you intend to have your business for that long. If your children are very young and 21 years from now you would not be comfortable transferring the shares of your business directly to them then you may want to wait.

2. As part of the reorganization to implement a structure like Figure 2, you may consider crystallizing your CGE at that time. When your existing common shares of Opco are exchanged for frozen preferred shares, you can elect to transfer your shares at a value somewhere between your adjusted cost base (ACB) and the fair market value (FMV) of your common shares. This allows you to elect an amount so that you can trigger a capital gain of up to \$750,000 so that you can claim your CGE. In doing this the ACB of the preferred shares received will be bumped up by \$750,000.
3. The corporate structure illustrated in Figure 2 also allows for ongoing purification of Opco. In particular, to qualify as a QSBC, in the 24

months immediately before the sale of the shares, the corporation must have more than 50% of its assets used in an active business carried on primarily in Canada. Since you never know when an interested party may offer to buy your company, it is prudent to always keep your Opco pure so that if you decided to sell, you have the most efficient tax structure. The structure in Figure 2 allows excess funds not needed for the operating business to be paid as a dividend to the Family Trust. The trustee/s of the discretionary Family Trust can then pay the dividend to Holdco. As long as Holdco is properly structured, the dividend will be considered an inter-corporate dividend and will not be taxable to Holdco. The added benefit of this structure is that it may provide creditor protection for Opco since all excess assets are removed from Opco. However, you should consult with your legal advisor with respect to the extent of the creditor protection provided.

Figure 2



Please contact us for more information about the topics discussed in this article.

4. Since a shareholder does not have to be involved in the day-to-day operations of the business, and dividends do not have to satisfy the “reasonability” test that salaries and bonuses do, paying dividends to family members that are shareholders, either directly or indirectly, can be a useful income-splitting mechanism (sometimes referred to as “dividend sprinkling”). The corporate structure in Figure 2 allows for dividend sprinkling. Dividends paid to the discretionary family trust can be paid or made payable to any of the adult beneficiaries of the trust and taxed at their marginal tax rate. However, you should proceed with extreme caution. It is imperative that no dividends be paid to minor children as they are subject to “kiddie tax”. Kiddie tax applies when a minor child receives a dividend from a private corporation. The dividend is taxed at the highest dividend tax rate regardless of the child’s marginal tax rate and cannot be offset by the basic personal exemption.

Another pitfall to watch out for is corporate attribution. Corporate attribution applies when property

is loaned or transferred to a corporation and a spouse or minor child benefits from this transfer. Corporate attribution applies to corporations other than a small business corporation (i.e., 90% or more of its assets are used in an active business). Therefore, as long as the Opco continues to be a small business corporation, these rules do not apply.

5. At this stage of your business (i.e., when there is no pending sale or plan to sell your business), it is easier to purify Opco for CGE purposes and to increase its attractiveness to buyers. At this stage you may consider transferring non-active assets to a separate company such as Holdco or a sister company. This may be the best time to transfer redundant assets held in Opco, such as real estate, an investment portfolio and life insurance etc. either to a Holdco or a sister company.

FACTORS AFFECTING THE MULTIPLE AND COMPANY VALUE

Here are some of the factors that influence the value of your company:

- Consistent, recurring, growing cash flow
- Certainty of cash flow
- Favourable industry dynamics
- Management team
- Growing diversified customer base
- Sustainable competitive advantage
- Price sensitive commodity product/proprietary offering
- Barriers to entry
- Public/private/scale

Some of the factors noted above are discussed briefly in Part 2 of this series, “Planning to sell your business or impending sale”.

The strategies discussed in this article are complex and there are numerous traps and pitfalls, both from a tax and legal perspective. Consequently, we advise you to get both legal and tax professionals involved to ensure you accomplish your goals and avoid unnecessary headaches.