RBC Wealth Management Services

The Navigator

Sale of Your Business – Part 2

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Planning to sell your business or pending sale

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 second in a four-part series, this article introduces some issues and tax planning strategies to consider when you are planning a sale or there is a pending sale of your business. 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.

One of the most common reasons for selling your business is retirement. This is because, more than likely, the majority of your assets that you will need for retirement are in your business.

Typical Reasons for Selling Your Business

At some point, you may contemplate getting out of your business. Although your reasons for wanting to sell your business will be unique to you, here are some of the more common reasons that business owners sell their business:

Retirement / Succession

One of the most common reasons for selling your business is retirement. This is because, more than likely, the majority of your assets that you will need for retirement are in your business.

Market conditions – An Up Economy or Market

This may be one of the best times to sell your business especially if your business has a good history of positive cash flows with an expectation for that to continue in the future.

Financial Difficulty

You may want to sell your business if it is having financial difficulty. However, here's where you have to decide whether it is better to cut your losses or to give it one last effort to turn your business around. If you can turn your business around you may be able to increase its value and hence the price you get.

Grow to the Next Level

You may be ready to move to the next challenge. You have gone as far as you wanted to with your business and you are ready for new opportunities.

Family / Health Issues

You or one of your family members may be experiencing health issues that make it difficult for you to continue to run your business.

Burnout/ Personal Exhaustion

You may just be exhausted because your business is too dependant on your personal effort. It may be difficult to sell your business if its success is totally dependant on you.

Death of the Owner

You may have inherited a business because the owner died and you have no interest in continuing to operate the business.

Shareholder Issues

Maybe you have business partners and either you are not getting along or you are part of divorce proceedings which force you to cash out your portion of the business.

Unsolicited Offer

You may have no intention of selling your business but you are approached by a buyer that makes an offer you can't refuse.

Issues and Concerns About Selling Your Business

As a potential vendor you will be very anxious and have lots of questions. Some of the common questions you may have are:

- What is my business worth?
- How do I find the right buyers?
- What price will I get and when will I receive the payments?
- How long will the process take?
- How long will I have to stay on after the sale?
- How much will I have left after taxes?
- How do I keep the sales process confidential?
- How do I manage my money after the transaction?

This is where having a great team of qualified and experienced advisors can really make a difference. Your team of advisors can help you understand, plan and structure the sale of your business

Generally speaking, selling to third-party buyers is the best option for an owner who wants to exit their business, maximize deal terms and cash out.

and manage your money after the sale. Your team of advisors may include accountants, business valuators, lawyers, tax specialists and financial advisors. Your team of professionals should work together and be involved early in the sale process.

Exit Options

There are only a limited number of options available to any private owner wanting to exit their business. Each situation is unique, so those options that are available can be limited even further by the specific circumstances of every business. Aside from taking a company public through an initial public offering, there are two basic approaches to exiting a business:

1. Selling or transferring to parties related to the business, such as a family member, management team or another partner or shareholder.

2. Selling to third-party buyers, which can include strategic buyers, financial buyers and other interested parties or serial entrepreneurs.

Although there are other exit options mentioned above, this series of articles only focuses on selling your business to a third party. Generally speaking, selling to third-party buyers is the best option for an owner who wants to exit their business, maximize deal terms and cash out.

You can approach third-party buyers, either strategic or private equity groups (PEGs), to determine their interest in purchasing your business or engage an intermediary to do so on your behalf. If you are attempting to get the highest and best offer for your business, engaging a professional to run the divestiture process usually results in the best deal.

Selling to a strategic buyer typically represents a very good option for most business owners. Strategic buyers are often in the same or a similar business to the company being sold. As such, they understand the markets served and the associated risks, and have the potential to extract various synergies. Due to their competitive position in the marketplace, a strategic buyer is usually also in the best position to pay a premium for the company. The drawback with opting for a strategic buyer is the requirement to disclose confidential information to the potential buyer – who may in some cases also be a competitor.

On the other hand, financial buyers, or PEGs, are looking for businesses with quality management teams, a strong earnings history, good margins, a sustainable competitive position in the industry, and attractive long-term prospects in which to invest. Often these buyers require the existing management team to stay on after the purchase as they generally don't have a management team of their own to put in place. PEGs pose less of a confidentiality concern to a seller due to their professional approach. Also, it's less likely they have another investment in the industry.

Getting Your Business Ready For Sale

There are a number of items you should consider when preparing your organization for sale. The most common factors to review and analyze are the management team, the company's management information systems, the customer base, the timing of the sale and cash flow.

Management Team

As an existing business owner, you should evaluate the depth and breadth of your current management team and consider making changes that would improve the business and its potential saleability. In addition, businesses that rely on one key shareholder or manager can create significant issues for a buyer, as this can increase the operating risk of the business and the potential that problems will arise if that key person leaves.

Management Information Systems

Well-managed companies usually have well developed management information systems.

Companies that attract a higher "multiple" when sold generally have a high quality cash flow that is very visible to the buyer.

The "it's all in my head" approach to management information is never the best answer when you are asking a top price for your business. Investing in and developing good management information systems will pay dividends as it gives the management team the tools to effectively manage and improve the business. This will hopefully lead to a higher value when the business is sold. The due diligence process can be onerous at the best of times, so accurate information can make this process much easier during the review.

Customer Base

Customer concentration is one of the most common problems in businesses. A potential buyer is ideally looking for a growing and diversified customer base. A business that is heavily reliant on one customer or a small number of customers presents a substantial risk due to the potential that the business's value will decline if a major customers leaves.

If no action is taken to improve things, then this may limit the divestiture options for your business, or when the business is divested the value is low and the sale proceeds are paid out over time. Where possible, bring on new customers and expand relationships with existing customers. This can result in a higher quality business and improved value on sale.

Timing of the Sale

Although it is not always possible, being able to decide when to sell the business can almost certainly lead to an improved value. Avoid selling when overall valuations are depressed or when results are poor because the business is going through a rough patch. Generally speaking, if a business is implementing a turnaround, one year of good results and good visibility of future results are necessary to shed the negative impression created by a bad year. Clearly, selling when the business is on the way up is always the best bet.

Cash Flow

Companies that attract a higher "multiple" when sold generally have a high quality cash flow that is very visible to the buyer. High quality cash flow is consistent, recurring, high margin and growing. A multiple is simply an expression of the market value of the business relative to a key statistic – whether earnings, cash flow or some other measure – that is assumed to relate to that value.

Cash flow tends to determine value and the higher the quality of the cash flow the greater the value. There are a number of factors that impact the quality of the cash flow. One of the best ways to improve cash flow is to put yourself in the buyer's position and critically review the risks attached to the cash flow in the business. Issues may be related to customer, supplier or key employee reliance or declining markets for certain aspects of the business. Where possible, take steps to reduce or mitigate those risks. Anything that creates a sense of risk or uncertainty in the buyer's mind will have an adverse effect on value. Once the offer arrives, it is very difficult to make any meaningful changes to the business that will result in an improved value, so do it before.

Steps to Execute the Sale of Your Business

The purchase and sale of a business is generally made up of the following steps:

1. Determine market value of business and assess current market dynamics
2. Prepare marketing documents to

If the business is currently not incorporated but there is a prospective purchaser, then think about incorporating the business and selling the shares of the corporation in order to utilize any remaining $750,000 (proposed to increase to $800,000 for dispositions after 2013) capital gain exemption (CGE).

present the business for sale

3. Complete research to identify possible buyers
4. Manage the market approach to the prospective buyers
5. Negotiate, oversee due diligence, structure and close the deal

Some of the professionals discussed previously will be instrumental in assisting you through these stages. The sale of a business is a complex process and it is highly recommended to engage a mergers and acquisition specialist to advise you throughout the transaction. If you would like to speak to an RBC specialist regarding the sale of your business, your RBC advisor can refer you to RBC Royal Bank Mid-Market Corporate Finance Group to discuss its services.

Tax Strategies to Consider

When you are selling your business, the purchase price you get is less important than the after-tax funds left in your pocket after it is all completed. Tax planning may allow you to sell your business at a lower price and still end up with the after-tax cash you expected. Because of this, it is important that buyers understand your tax objectives and work together with you to create tax efficiencies for all parties. Here's where it is critical for buyers and sellers to get professional tax advice early in the transaction process so that the deal can be structured properly. The following is a discussion of the various tax strategies that may be considered at this stage of selling your business.

Incorporate Your Business Before Sale

If the business is currently not incorporated but there is a prospective purchaser, then think about incorporating the business and selling the shares of the corporation in order to utilize any remaining $750,000 (proposed to increase to $800,000 for dispositions after 2013) capital gain exemption (CGE). In this case, the shares do not have to be held for at least two years to qualify for the CGE.

Sale of Assets

Determine if the purchaser is interested in purchasing the assets of your business or the shares of your business. If they are interested in purchasing the assets of your business, then you will generally not be eligible to claim the CGE. As a result, you might be able to negotiate a higher sale price so the after-tax proceeds of an asset sale are similar to a share sale.

However, asset sales can be very attractive if the majority of the assets being sold are considered "goodwill." In this case, only 50 per cent of the gain on the sale of goodwill is taxable in the corporation at active business tax rates and the other 50 per cent gets added to your corporation's capital dividend account (CDA), but only at the end of the corporation's taxation year, and can be paid out to you tax-free as a capital dividend if the CDA is positive after the taxation year in which the disposition occurred. This could result in a maximum tax rate on the goodwill portion of the sale proceeds of only 12-15 per cent (although some of the proceeds remain in the corporation tax-deferred) compared to a maximum capital gains tax rate of 20-25 per cent on a share sale.

Hybrid Asset Sale Structures

There are some more sophisticated tax strategies that may allow you to claim both the CGE for part of the proceeds as a qualified small business corporation (QSBC) share sale and treat the remaining proceeds as an asset sale. This is beyond the scope of this article but if you are interested in finding out more you should consult with your qualified tax advisor.

Sale of Shares

If the purchaser is willing to purchase the shares of the business, then ensure that the shares qualify as QSBC shares in order to utilize any remaining CGE. If there are passive assets in the corporation, such that less than 90 per cent of assets are being used

You may consider life insurance, using the funds in the holding company, as a tax-effective vehicle to minimize the taxes on the holding company shares at death and withdraw monies from the holding company on a tax-free basis for beneficiaries.

in an active business at the time of sale, your qualified tax advisor may have to restructure or "purify" your business assets prior to sale to ensure that the business qualifies for the CGE. However, if there is a pending sale it may be more difficult to restructure the business on a tax effective basis.

Here is a brief outline of the various purification techniques that your qualified tax advisor may implement:

Non-taxable methods

- Pay down liabilities including shareholder loans
- Pay out capital dividends if there is a positive Capital Dividend Account balance in your corporation
- Accelerate active asset purchases
- Pay a return of capital dividend

Taxable Methods

- Pay salaries or taxable dividends
- Pay passive assets as a dividend in kind
- Sell passive assets and pay down debt or invest in active assets

Tax-Deferred Methods

- Transfer passive assets and related debt into a subsidiary
- Other corporate reorganizations

Ongoing purification techniques were discussed in Part I of this series of articles.

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.

Safe-Income Strip

In addition to claiming the CGE on a QSBC share sale, you may be able to effectively receive some of the sale proceeds tax-free into a holding company instead of paying tax immediately at capital gains tax rates. This strategy is called a "safe-income strip." The logic behind this strategy is that you transfer assets on a tax-deferred basis from the company you are selling to a holding company. This reduces the value of the sale company and therefore reduces the capital gain that results on the sale of its shares. The portion of assets transferred to your holding company will not be taxed until those funds are removed from the holding company. You will need to speak to your qualified tax advisor to determine if this strategy is available to you.

The portion of the proceeds that can be received tax-free into your holding company will depend on a tax calculation relating to the active corporation's prior year's retained earnings for tax purposes. This portion of the tax on the sale proceeds received in a holding company is deferred until either death or such time they are withdrawn during your lifetime and taxed as a dividend. Although dividend tax rates are generally higher than capital gains tax rates, the tax deferral on a portion of the capital gain is the main advantage, and this can last many years as long as the funds are retained in the holding company. You may also consider life insurance, using the funds in the holding company, as a tax-effective vehicle to minimize the taxes on the holding company shares at death and withdraw monies from the holding company on a tax-free basis for beneficiaries. You also have to consider the cost of insurance to determine whether this strategy is cost effective.

The steps to access safe income are as follows:

1. You incorporate a holding company, Holdco.

Generally, the dividends paid between Opco and Holdco (connected corporations) are tax-free.

2. You transfer shares of your operating company, Opco shares, to Holdco on a tax-deferred basis. You may choose to keep a portion of the shares personally to utilize your CGE and transfer the rest to Holdco.

3. You can then access safe income through the following methods:

- Opco can pay a cash dividend to Holdco
- Opco can pay a dividend in kind to Holdco
- Paid-up capital increase
- Purchase of shares for cancellation

Generally, the dividends paid between Opco and Holdco (connected corporations) are tax-free. However, if your corporation pays a dividend greater than safe income, that dividend would be re-characterized to be a capital gain resulting in an immediate tax liability. Therefore great care must be taken in calculating safe income and the exact amount of the dividend that can be paid tax-deferred.

Other Tax Minimization Strategies

If the capital gains on the sale are expected to be substantial, speak to your qualified tax advisor regarding other advanced tax strategies that can be considered to reduce and/or defer some of your capital gains tax.

Financial Planning

Finally, consider having your RBC advisor prepare a financial plan for you to determine if the expected after-tax sale proceeds will be adequate to enable you and your family to meet your retirement income and estate planning goals.

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

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