

# The Navigator



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## Planning the sale of your business

### Sale of your business – Part 2

On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.

Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.

The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

This article is the second in a four part series intended to highlight key strategies to consider at different stages of your business. It isn't exhaustive but it may help you to gain deeper understanding of some of the strategies you are already using or that might be suggested to you. Part 2 introduces some issues and tax planning strategies to consider when you are planning a sale or there is an imminent sale of your business. It discusses the typical reasons for selling your business, the concerns you may have about selling your business, your exit options, getting your business ready for a sale and the tax planning strategies to consider at this stage.

The other articles in the series are:

**Part 1: Preparing Your Operating Company for Future Sale**

**Part 3: Year of Sale of Your Business**

**Part 4: Year After the Sale of Your Business**

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 and manage your money after the sale.

In this article, the terms ‘corporation’ and ‘company’ are used interchangeably to refer to a Canadian-controlled private corporation (CCPC). In simple terms, a CCPC is a private Canadian corporation that is not controlled by a non-resident of Canada, a public corporation or a combination; and no class of shares of the corporation is listed on a designated stock exchange. This four part series does not apply to public corporations or to businesses operating as a partnership or a sole proprietor.

*This article may outline strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified legal and/or tax advisor before acting on any of the information in this article.*

### **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 have for selling 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. Selling is one way of accessing the value of your business to fund your retirement.

#### **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 dependent on your personal effort. However, it may be difficult to sell your business if its success is totally dependent 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.



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.

## 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 and manage your money after the sale. Your team of advisors may include accountants, business valuers, 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 can result 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, 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



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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 business 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. 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 customer leaves.

If no action is taken to improve things, you may be limited in the number of divestiture options for your business, or when the business is divested, the value will be low and the seller will ask to have the sale proceeds 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 can give you better results.

#### 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

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a number of factors that impact the quality of 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 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 that you 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, an 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 you retain after the sale. 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 your business is currently not incorporated but there is a prospective purchaser, think about incorporating the business and selling the shares of the corporation to utilize your lifetime capital gain exemption (LCGE) (increased to \$800,000 in 2014 and indexed for subsequent years). In this case, your shares do not have to be held for at least 24 months to qualify for the LCGE as long as all the other requirements are met.

#### 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, you will generally not be eligible to claim the LCGE. 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.

In the past, asset sales were considered very attractive if the majority of the assets being sold were considered "goodwill." This was because only 50% of the gain on the





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sale of goodwill was taxable in the corporation at active business tax rates and the other 50% was added to your corporation's capital dividend account (CDA). This generally resulted in a maximum tax rate on the goodwill portion of the sale proceeds of only 12-15% (although some of the proceeds remained in the corporation tax-deferred). However for dispositions of goodwill after December 31, 2016, the rules have been changed.

Starting January 1, 2017, goodwill that is purchased will be treated similar to tangible depreciable assets such as a building or equipment used in your business and it will have its own capital cost allowance (CCA) class subject to a write-off rate of 5% for any new purchases. When a corporation sells goodwill after December 31, 2016, for more than its original cost, there may be recapture of any CCA that was claimed and a capital gain. Recapture is included in the corporation's income and is taxed at active business income tax rates. In the case of internally generated goodwill, the original cost would be NIL and there would be no recapture. Like before, only 50% of the capital gain on the sale of goodwill is taxable but the tax rate that applies is the corporate tax rate on passive investment income. The passive investment income tax rate is significantly higher than the active business income tax rates making asset sales much less attractive than share sales. The non-taxable portion of the capital gain is added to the CDA and can be paid out tax-free to the shareholders as a capital dividend to the extent that the corporation's CDA is positive.

#### Hybrid asset sale structures

There are some more sophisticated tax strategies that may allow you to claim both the LCGE for part of the proceeds as a qualified small business corporation (QSBC) share sale and treat the remaining proceeds as

an asset sale. However, because of the changes to the tax treatment of the sale of goodwill just discussed, this option may not be as popular. A discussion of hybrid asset sale structures is beyond the scope of this article but if you are interested in finding out more you should consult with a qualified tax advisor.

#### Sale of shares

If the purchaser is willing to purchase the shares of your business, ensure that the shares qualify as QSBC shares in order to utilize your LCGE. If there are passive assets in the corporation, such that less than 90% of assets are being used in an active business at the time of sale, your qualified tax advisor may have to restructure or "purify" your corporation prior to sale to ensure that the business qualifies for the LCGE. 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 a qualified tax advisor may implement:

#### Non-taxable methods

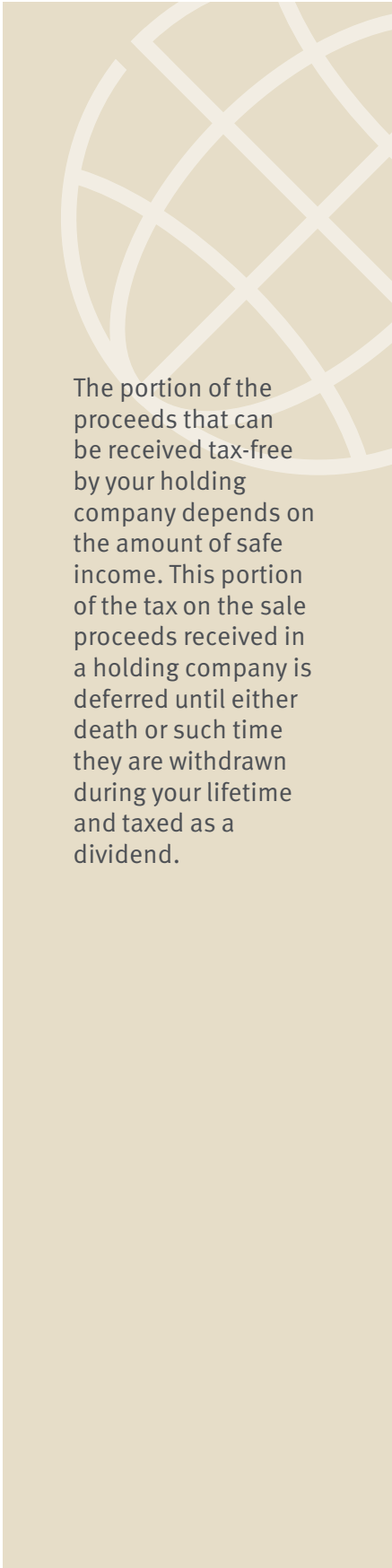
- Pay down liabilities including loans from the shareholder
- Pay out capital dividends if there is a positive CDA balance in your corporation
- Accelerate active asset purchases
- Pay a return of capital dividend

#### 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 holding company
- Other corporate reorganizations



The portion of the proceeds that can be received tax-free by your holding company depends on the amount of safe income. 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.

Ongoing purification techniques are 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 that discusses capital gains exemption on private shares. Ask an RBC advisor for a copy. If you need further information please contact a qualified tax advisor.

#### Safe-income strip

In addition to claiming the LCGE on a QSBC share sale, you may be able to effectively receive some of the sale proceeds tax-deferred in holding company instead of paying tax immediately at capital gains tax rates. This strategy is commonly referred to as a “safe-income strip” (safe income is generally a corporation’s retained earnings accumulated after 1971 restated on a tax basis). 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 should not be taxed until they are withdrawn from the holding company. You will need to speak to a qualified tax advisor to determine if this strategy is available to you.

The portion of the proceeds that can be received tax-free by your holding company depends on the amount of safe income. 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, which can last many years, can be advantageous. You may also consider using the funds in the holding company to purchase life

insurance. Life insurance can be 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 have to consider the cost of insurance to determine whether this strategy is cost effective.

The typical steps to access safe income are as follows:

1. You incorporate a holding company, Holdco.
2. You transfer shares of your operating company, Opco, to Holdco on a tax-deferred basis. You may choose to keep a portion of the shares personally to utilize your LCGE and transfer the rest to Holdco.
3. Holdco can then access safe income through the following methods:
  - Opco pays a cash dividend to Holdco
  - Opco pays a dividend in kind to Holdco
  - Opco increases its paid-up capital
  - Opco purchases Holdco shares for cancellation (redemption)

Generally, the dividends paid between Opco and Holdco are tax-free if they are connected corporations. Corporations are connected to each other if one owns more than 10% of the issued share capital (having full voting rights) of the other corporation and it also owns more than 10% of the fair market value of all of the issued shares of the capital stock of the other corporation (i.e., more than 10% of the votes and the fair market value of all share capital). However, if your corporation pays a dividend greater than safe income, that dividend could be re-characterized as a capital gain resulting in an immediate tax liability even if the corporations are connected. Therefore, great care must be taken in calculating safe

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

income and the exact amount of the dividend that may be paid on a tax-deferred basis.

#### Other tax minimization strategies

If the capital gains on the sale are expected to be substantial, speak to a 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 an 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.



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