Wealth
Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Preparing your operating company for future sale

Sale of your business – Part 1

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.

Owning a business presents opportunities and challenges for tax, retirement and estate planning; on the one hand keeping your business structure simple makes things less complex and less costly to operate. On the other hand, the choice of business structure can determine if you are able to minimize your tax on an ongoing basis by income splitting with family members and also allow you to minimize the taxes payable in the future if you eventually sell your business to a third party.

If you are in the highest tax bracket, being able to multiply access to the LCGE could result in significant tax savings on the sale of QSBC shares if you are able to split the capital gain with other family members.

This article is the first 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 1 introduces some tax planning strategies to consider when you are operating your business as a going concern. It assumes you have no immediate plans to sell but you may consider selling in the future.

The other articles in the series are:

Part 2: Planning the Sale of Your Business

Part 3: Year of Sale of Your Business

Part 4: Year After the Sale of Your Business

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.

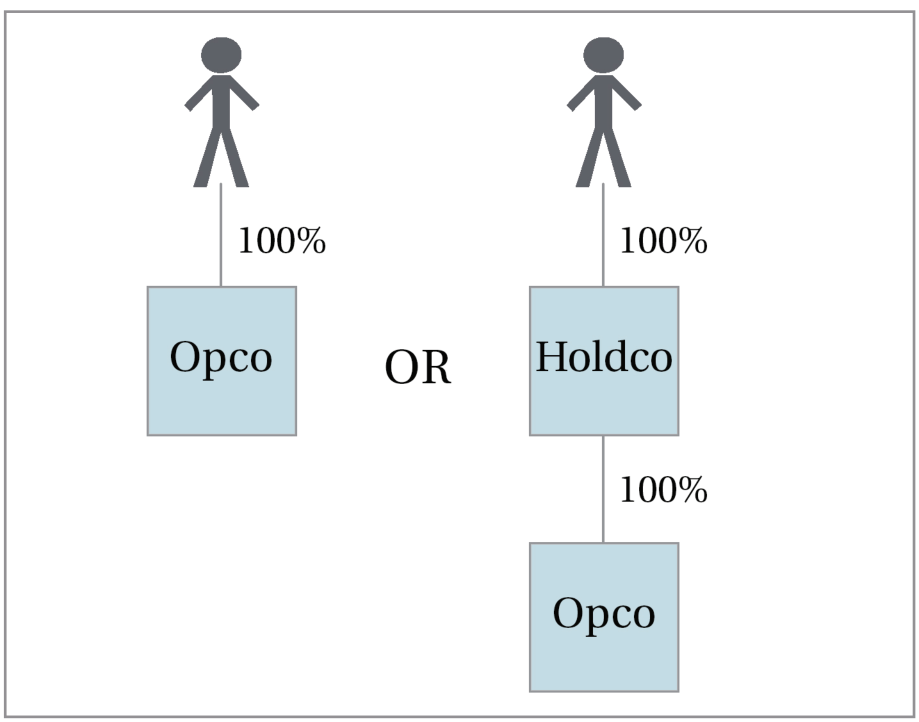
The use of a family trust may allow for more flexibility in terms of tax planning and increased control. A family trust may be necessary if minors are involved.

Current corporate structure

Even when selling your business is a distant event, when you are 100% owner of your operating company (Opco) or 100% owner of a holding company (Holdco) that owns 100% of your Opco (see Figure 1), your business may not be structured in the most tax-efficient manner for a future sale. This type of structure would not easily allow for the multiplication of the lifetime capital gains exemption (LCGE) with other family members on the sale of the shares of your qualified small business corporation (QSBC). If you are in the highest tax bracket, being able to multiply access to the LCGE could result in significant tax savings on the sale of QSBC shares if you are able to split the capital gain with other family members. Each individual resident in Canada can claim a LCGE on the disposition of QSBC shares. The LCGE was increased effective for 2014 to $800,000 for dispositions of QSBC shares and is indexed for years after 2014 (you can find the current year LCGE on the Canada Revenue Agency's (CRA) website).

To illustrate the tax saving that can result from being able to multiply access to the LCGE, let's look at an example. For simplicity, we will assume that the LCGE is $800,000 (it is now more than $800,000 because of indexation). Let's also assume that the total capital gain on the sale of your qualifying business is $1,600,000. If you owned 100% of the shares then you would only be able to shelter $800,000 of the capital gain by claiming your LCGE. Assuming your marginal tax rate is 50%, total tax on the capital gain would be $200,000 (1,600,000 capital gain – 800,000 LCGE = 800,000 unsheltered capital gain x 50% = taxable capital gain of 400,000 x 50% tax rate = 200,000). However, if instead you and one other family member owned the shares being sold then each of you may be able to claim an $800,000 LCGE sheltering the entire $1,600,000 capital gain. This would result in tax savings of $200,000.

Figure 1



It is important to consult with a qualified tax advisor before paying inter-corporate dividends to ensure that they do not fall into the anti-avoidance provisions.

Consider a more flexible structure ("Estate Freeze")

If your corporate structure looks like one of the two depicted 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. This may allow you to multiply the LCGE available on the eventual sale of your business and may allow for income splitting with your family members. The step-by-step procedures to implement this structure are beyond the scope of this article but the major components are briefly mentioned.

The structure in Figure 2 is usually achieved by doing an estate freeze where you exchange the shares you currently own for fixed value preferred shares and your corporation issues 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 may allow you to keep your operating business as a QSBC by paying out excess funds in the Opco to the Holdco rather than directing the excess funds to the other beneficiaries of the trust. This structure may also provide better creditor protection; however, you should speak to a qualified legal advisor about the extent of creditor protection provided from the structure illustrated in Figure 2.

Ongoing purification techniques

There are a number of structures possible to implement an estate freeze. The following is an example of one alternative that may allow for ongoing purification using a trust with a corporate beneficiary. Purification refers to maintaining your Opco's status as a QSBC by removing surplus assets that are not part of its active business. Here are the typical steps to implement this structure:

1. Mrs. A establishes Holdco and subscribes for super voting special shares to maintain control of 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 frozen preferred shares of Opco worth $800,000, non-voting preferred shares for the balance of the fair market value of Opco and nominal special voting shares.

4. The Family Trust subscribes for non-voting common shares of Opco.

5. When Opco generates after-tax surplus funds 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 allocated by the Trust to either the family members that are beneficiaries of the trust or Holdco (or both).

6. Dividends allocated to the family member beneficiaries are taxed in their hands at their marginal tax rates (assuming the trust is properly structured and none of the attribution rules in the Income Tax Act (Act) apply). Dividends allocated to Holdco may be

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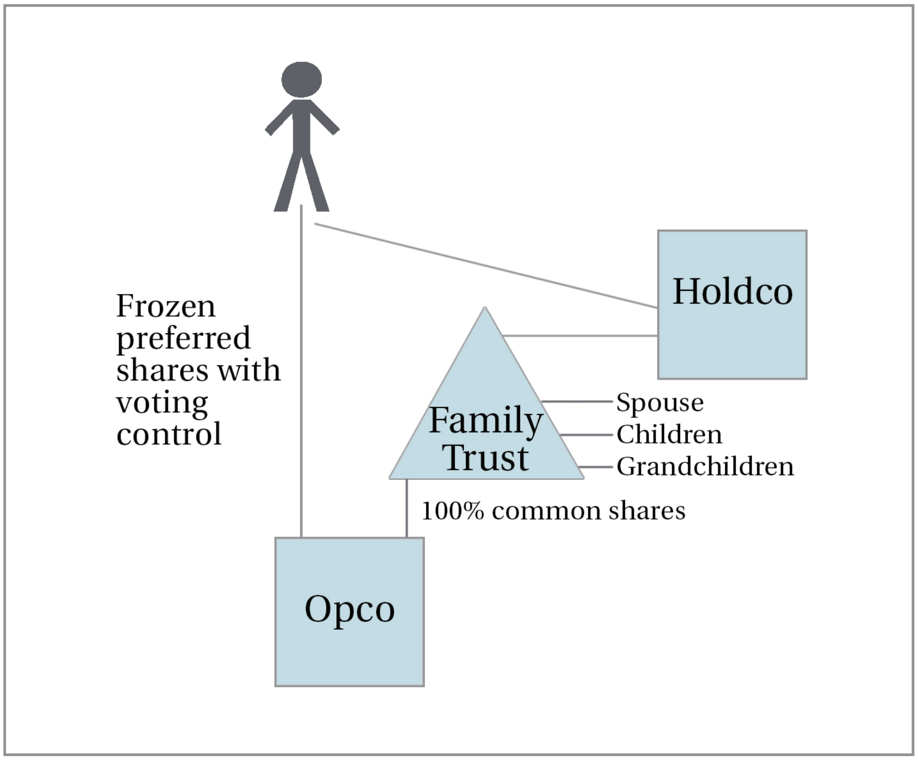
considered a tax-free inter-corporate dividend from a connected corporation assuming they are not re-characterized by any anti-avoidance provisions in the Act. It is important to consult with a qualified tax advisor before paying inter-corporate dividends to ensure that they do not fall into the anti-avoidance provisions.

Figure 2



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"[1]).

Tax strategies to consider at this stage of your business

1. The LCGE 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 it is discussed in another article on the capital gains exemption on private shares. Ask an RBC advisor for a copy. If you need further information please contact a qualified tax advisor. Each individual shareholder is entitled to claim a LCGE during their lifetime on the disposition of qualifying property. Instead of only being able to claim one LCGE, if we assume that the LCGE is $800,000, a family of four can shelter $3.2 million of capital gains, resulting in significant tax savings. The structure in Figure 2 puts you in a better position to multiply the LCGE in the future. Each beneficiary of the trust that is an individual can claim a LCGE when the shares of your qualifying business are sold. For your family members to qualify for the LCGE, the trust in Figure 2 must hold the shares for at least 24 months before the sale because the shares were issued from treasury. You would not be able to set this structure up immediately before a sale to multiply the LCGE 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 LCGE.

   In addition, for each beneficiary to be able to claim their LCGE, the qualifying capital gain must be taxable in their hands. This can only be done by paying (or making payable) the taxable capital gain on the sale of the QSBC shares to the beneficiaries. Therefore, you have to be comfortable with each beneficiary receiving their portion of the sale proceeds that is taxable in their hands.

   There is a 21-year deemed disposition rule for trusts, so 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 LCGE 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 sufficient enough for you to claim your LCGE. In doing this, the ACB of the preferred shares received will be bumped up to the amount you elected.

3. The structure illustrated in Figure 2 may also allow 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 may not know when an interested party may offer to buy your company, it is prudent to always keep your Opco ready so that if you decided to sell, you have the most tax-efficient structure. The structure in Figure 2 may allow excess funds not needed for the operating business to be paid

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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 may be considered an inter-corporate dividend and may not be taxable to Holdco. In recent years the income tax rules with respect to inter-corporate dividends have been severely restricted. It is important to discuss with a qualified tax advisor whether your operating company will be able to pay a tax-free inter-corporate dividend to the holding company. Assuming you are able to pay tax-free inter-corporate dividends 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. You should consult with your legal advisor with respect to the extent of the creditor protection provided.

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"[1]). 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. Where there are minor beneficiaries of the family trust, 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 child's basic personal exemption.

   Another pitfall to watch out for is corporate attribution. Corporate attribution applies when property is loaned or transferred by an individual to a corporation and their spouse or minor child can benefit from this transfer. A typical estate freeze is viewed as a transfer to a corporation. 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 in the near future), it is easier to purify Opco for LCGE purposes and to increase its attractiveness to buyers. 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 company value

At this stage of operating your business, you'll want to understand the various factors that affects your company's value to ensure

1) In the 2017 federal budget, the government identified certain strategies involving private corporations that they believe provide an unfair tax advantage to high-income individuals. One of these strategies involves dividend sprinkling (directing dividends that would otherwise be taxed in the hands of an individual at a high tax rate to family members who are subject to a lower tax rate or who may not be taxable at all). The government intends to release a paper in the coming months setting out the nature of these issues in more detail as well as proposed policy responses.

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

that you continue to build on your strengths, work on your weaknesses, take advantage of opportunities and mitigate risks so that you can continue to grow your business. In addition, some of the strategies discussed above will require you to properly value your business.

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 the Sale of Your Business".

Conclusion

The strategies discussed in this article are complex both from a tax and legal perspective, but have the potential to save significant amounts of tax. Consequently, we advise you to get both legal and tax professionals involved to ensure you accomplish your goals and avoid unnecessary headaches.