Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

Selling your business

A checklist of tax strategies to consider when selling your business

When selling your business, there is more than the purchase price to consider; the real bottom line is the after-tax funds you retain after the sale. Tax planning ahead of time may offer you more flexibility in negotiating the terms of the sale and still end up with the same after-tax cash you expected. This article provides a non-exhaustive checklist of Canadian tax and financial planning strategies that you can consider with your professional advisors before and after selling your business.

Planning for the sale of your business

- If your business is incorporated, consider whether you qualify for the lifetime capital gains exemption (LCGE) if you sell the shares of your business. The LCGE allows you to eliminate up to $800,000 (2014 threshold and indexed annually thereafter) of capital gains realized on the sale of qualifying shares. One of the criteria that needs to be met in order to qualify is that all or substantially all of the business' assets are used principally in an active business carried on primarily in Canada at the time of sale. The Canada Revenue Agency (CRA) generally takes the position that all or substantially all means 90% or more. As a result, your corporation may need to be "purified" prior to the sale. Purification requires removing non-active assets from the corporation which can be done in a number of ways including making distributions of surplus cash or assets to shareholders. Non-active assets generally consist of investments and other assets not required in the day-to-day activities of the business. For more information on the criteria required for shares to qualify for the LCGE, ask an RBC advisor for the article titled, "*Capital Gains Exemption on Private Shares*".

- 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 in order to utilize any of your LCGE. This may allow you to reduce or eliminate any capital gains tax that you may have to pay.

- If you plan to sell in the future and expect the value of your business to increase, there may be some steps you can take today to reduce the taxes you will pay on the eventual sale of your business. Consider implementing an estate freeze so that some or all of the future growth of your business can accrue to other family members, either directly or through a family trust. This strategy may in certain circumstances allow you to multiply the use of the LCGE among family members if you have an incorporated business and you are selling its shares. However, keep in mind that the after-tax value of the growth allocated to family members will now belong to them.

- By reorganizing your company prior to the sale, you may be able to convert a portion of the capital gain that would be taxable at the time of sale into a dividend that will be taxed in the future. This strategy is called a “safe income strip”. The strategy results in receiving some of the sale proceeds tax-free in a holding company instead of paying capital gains tax immediately. Tax is deferred on the proceeds until they are withdrawn from the holding company or at the time of death. Dividend tax rates are generally higher than capital gains tax rates; however, the tax-deferral, which can last many years, can be advantageous. You can consider using funds in the holding company to pay premiums toward a life insurance policy to reduce the taxes at death. Speak to your qualified tax advisor to determine if this strategy is available to you.

- Consider paying yourself a retiring allowance from the corporation prior to the sale. If you worked for your corporation prior to 1996, you may be able to transfer all or a portion of your retiring allowance to your RRSP on a tax-deferred basis without impacting your RRSP contribution room.

Selling your business

- If your business is incorporated, you can choose to sell the shares of your corporation or the assets inside the corporation. If you sell the assets in the corporation, you will not be eligible to claim the LCGE upon the sale. In this case, you can consider negotiating a higher sale price to reflect the additional tax you will incur on the sale.

- Instead of receiving all the sale proceeds in the year of sale, consider taking back a promissory note and having the purchaser pay the proceeds over a number of years, assuming you have an adequate guarantee of payment and an attractive interest rate on the note. In this case, a capital gain reserve may be taken to spread the capital gain on the sale over a maximum of five years. If your marginal tax rate is expected to be lower in the near future, the deferral of the capital gain can help minimize your overall tax on the capital gain, assuming not all of it qualifies for the LCGE.

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- If the purchaser is another company, instead of receiving only cash in exchange for your private shares, consider receiving some shares of the purchaser as consideration. It may be possible to receive the purchaser’s shares in exchange for your shares on a tax-deferred basis.

- Consider having a financial plan prepared for you to determine if the after-tax sale proceeds are enough for you and your family to meet your retirement and estate planning goals. Your qualified tax advisor and/or your licensed life insurance representative can also discuss planning, such as using insured annuities, family trusts or tax-exempt life insurance for the post-sale proceeds to maximize retirement income, minimize tax and maximize your estate.

After the sale of your business

- In some cases, you may want to consider the pros and cons of setting up an Individual Pension Plan (IPP) or a Retirement Compensation Arrangement (RCA) to reduce capital gains tax. If you have structured the sale as an asset sale, your corporation’s contributions to these retirement plans may assist in reducing and deferring the corporate tax on the sale. For this strategy to work, it is recommended that you continue to receive T4 income from and provide pensionable service to the corporation that set-up the IPP or RCA for a few years after the sale.

- Consider using some sale proceeds to make a gift to either a registered charity or to your own charitable foundation. The donation tax credit can reduce the taxes payable from the sale of your business. In order for this strategy to be effective, the charitable donation must be made in the year of sale. Since the donation is irrevocable, ensure that you have enough remaining assets to meet your retirement income and estate planning goals.

- If you expect to reinvest some or all of the sale proceeds in shares of another active Canadian business, consider the timing of the reinvestment. If the reinvestment is made within the year or within 120 days after the year of sale, you may be able to defer the recognition of some or all of the capital gain on the original sale.
- If you have publicly traded securities that are in a capital loss position, consider selling these securities prior to year-end to trigger the capital loss. This may help offset the capital gain on the sale of your business. This decision should be made based on the investment merits of the securities. If you want to repurchase the security, you may want to wait 30 days before repurchasing to avoid the loss being disallowed under the superficial loss rules.
- Consider purchasing flow-through shares prior to year-end to help reduce the tax relating to the sale of the business. A flow-through is a type of tax-advantaged investment designed to encourage investing in resource companies engaging in exploration and development in the mining, oil and gas, and renewable energy and energy conservation sectors. If structured properly, Canadian tax laws allow certain expenses incurred by the resource company to be "renounced" or "flowed through" to you. You can deduct these expenses personally, on your tax return, up to the maximum you paid for the investment. Flow-through investments are more speculative in nature and its investment merits and possible drawbacks should be considered before making a purchase. For more information on considerations to make before purchasing a flow-through investment, ask an RBC advisor for the article titled, "Flow-Through Shares and Limited Partnership Units".

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Get the right advice

There are many strategies that may be available to you when selling your business that may help you save tax. If the capital gains on the sale are expected to be substantial, speak to your qualified tax advisor regarding the strategies discussed above or more advanced strategies that may be considered prior to and after the sale for tax and/or estate planning reasons.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information inthis article is not intended to provide legal, tax, or insurance 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 tax, legal, and/or insurance advisor before acting on any of the information in this article.

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