Volume 6, Issue 2

BUSINESS OWNER SPECIAL EDITION

PERSPECTIVES

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Inside this edition

- Strategies for building and maintaining a strong, loyal employee base
- Protecting business continuity with a Power of Attorney
- The importance of a comprehensive exit strategy
- Options to consider in building your retirement nest egg as a business owner
- Unlocking the potential value of equipment leasing

RBC Wealth Management

From the desk of David Agnew

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In recent decades, rapid advancements in technology, changes in the economy and shifting societal trends have had a large impact on many Canadian businesses and industries. These types of changes contribute to both the entry and exit of thousands of businesses within the marketplace each year in Canada.

In this special edition of *Perspectives*, we focus on relevant topics and information to help business owners throughout the entire life cycle of a business, from start-up and growth all the way to developing an exit strategy and succession, recognizing that strategic planning at every phase can go a long way in helping to achieve business goals, adapt to change and build towards sustainable success.

When it comes to growing a successful business, we explore the potential behind the integration of credit and the possible benefits of leasing when investing in new business equipment. And for business owners thinking about how to build and preserve their workforce, especially amidst shifts in the labour force and the growth of temporary or freelance work, "Employee loyalty: Attracting and retaining top talent," provides an overview of potential options.

With recent research indicating that approximately 40 percent of Canadian entrepreneurs are likely to exit their business within the next five years, succession is a growing focus for many. In "Keeping it in the family: managing conflict through planning," we examine intergenerational business succession and strategies to help ensure a smooth process. In "Your business exit strategy," we discuss the various options for transitioning out of a business and considerations in choosing and planning for each. Additionally, for business owners who may opt to sell their business, this edition features articles on business valuation and planning for a tax-efficient transition.

For all business owners, planning for the unexpected and safeguarding a business are important aspects as well, and this edition includes discussions on key person insurance, shareholders' agreements and estate planning that takes your business interests into account.

Whether you're a newer entrepreneur or you're a longtime owner with retirement on the horizon, I encourage you to contact your RBC Wealth Management advisor about the topics featured in this issue and to explore ways to address your business, family and personal wealth management needs and goals.

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Keeping it in the family: managing conflict through planning

With statistics indicating that approximately 60 percent of Canada's business owners (of small- and mid-sized enterprises) are aged 50 or over, business succession may be getting closer on the horizon for many.[1] And when it comes to succession among business owners of all ages, findings from a recent study conducted by The Economist Intelligence Unit (EIU), sponsored by RBC Wealth Management, show that almost half have intentions or hopes of passing the business on to their children.

Yet while transferring a business to the next generation may often be viewed as an ideal scenario, the process itself can sometimes present a different set of challenges and complexities when family members and family dynamics are involved. The types of challenges may vary depending on circumstances, but according the EIU study, a main source of difficulty may be a misalignment in intentions and expectations between generations, and perhaps a lack of ongoing dialogue and early planning in that regard.

Based on the study findings, while 50 percent of younger individuals say they're expected to take over the family business, many identify having other career goals they wish to pursue. And among the owner generation, more than half say that maintaining the interest of a family successor is a challenge, as there's a strong overall belief that the younger generation would prefer to join the corporate world or start their own business rather than take over an existing family business.

"Succession planning is a challenge for any business but it takes on another dimension when the successors are your own family members," says Mark Skeggs, Vice President, Business Owner Specialist, RBC Wealth Management Services.

When putting together a succession plan, Skeggs suggests that business owners and their families consider the following points to help ensure a smooth and conflict-free process.

It's never too early — create and implement a clearly defined business succession plan now

Don't underestimate the value of starting your family business succession planning process early. Advance planning can help make transitions easier and assist you in making better long-term decisions. As a business owner, start thinking about a suitable succession plan as early as possible.

Consult qualified advisors

Assemble a team of qualified advisors (legal counsel, tax specialist, financial advisor and business facilitator) to help you build your business succession plan. An experienced family business facilitator can help you discuss sensitive issues with family members, provide objectivity, find constructive ways to resolve conflicts and establish priorities in the succession process.

Identify suitable candidates

Identify the qualities you're looking for in a suitable successor at the outset and then honestly evaluate the strengths and weaknesses of each candidate for the position.

You should ask yourself the following questions: Who demonstrates the commitment and leadership qualities I'm looking for? Do certain family members have more aptitude and interest in the business than others? Is there a suitable successor in the family? Can they work well with others who may also be involved in the business?

If there is no one individual who satisfies all of the criteria you have in mind for a successor, consider dividing the responsibilities of operating the business among multiple family members and creating clearly defined roles for each person. This way, each member has the opportunity to excel in his or her respective area of interest. However, when splitting responsibilities, be cautious of putting family members into situations where they are likely to compete with each other. Doing so may lead to hostility, which would be counterproductive for the success and longevity of the business.

Based on the study findings, while 50 percent of younger individuals say they're expected to take over the family business, many identify having other career goals they wish to pursue.

Treat everyone fairly

Although it may not be possible to treat all family members equally, try to ensure that they are treated fairly. Given the differing levels of commitment that your children may have shown, should you divide the business equity equally between or among them? Should those who may not be involved in the business be treated equitably from a financial perspective? If so, it may be more palatable to family members if they understand that the ultimate decision is yours and that family members who are not involved are being treated generously to compensate for the fact that they have been excluded from the business.

Set realistic goals together

Begin by writing down achievable goals for the business as a family. When a family establishes the long-term outlook for the business together, this will help to foster a team-oriented environment and will likely minimize any risk of conflict. Revisit these goals periodically and hold family members accountable for meeting these mutually agreed-upon goals.

Communicate regularly and effectively

Err on the side of over-communicating rather than under-communicating. In fact, once you have identified a successor, involve them in your succession plan and share your long-term goals with them and with any other family members who are involved. The gesture will likely be seen as collaborative and inclusive. By including your chosen successor, you can help them make an informed decision about whether they want to participate and, if so, to what extent. In addition, when you involve family members and discuss their concerns, such open communication helps to clarify everyone's expectations about their roles and their commitment to making the transition a success. Their input can minimize potential conflict and help to maintain stability in the business and in the family.

Many forward-thinking families have gone so far as to implement formal governance structures, including regular family meetings and co-operative decision-making. Communication should be open and direct at these formalized family meetings, and all participants should be encouraged to suggest topics for discussion. Use the meetings as a time to learn what each person cares about and what their motivation is for their position. You may even want to consider inviting a business facilitator to ensure the preliminary meetings proceed smoothly and to attend when the issues discussed are likely to cause tension or hostility. You may also arrange for your team of objective qualified advisors to attend occasionally.

Implement co-operative decision-making

Whenever possible, try to address issues as they arise in a timely manner and take an open-minded approach to resolving them. It is important to brainstorm a variety of possible resolutions and think outside the box. Devising new and interesting options together and moving away from authoritative decisions will create a sense of co-operative decision-making. So, have an open discussion about the potential solutions during your family meetings, weigh the options and combine elements of different solutions when possible.

Establish a clear process for managing conflict

The process for managing conflict is as important as the outcome. If you choose a formal governance structure, this could include a shareholders' agreement to deal with critical and sometimes uncomfortable questions such as remuneration, exit and entry, and death. In addition, to minimize the effect of any conflict on the company, the shareholders' agreement could contain a conflict resolution policy. For example, your policy could require the use of mediation. If this process is not fruitful, the conflict could then be submitted to arbitration rather than to the courts. This procedure can help preserve the confidentiality of the company's business, shorten the time it takes to resolve conflicts and minimize the costs of a dispute.

Continue involvement after succession

As you approach your retirement date, try to give your heir or heirs the lead in implementing the succession plan. This can improve the odds of a successful transition. However, you should have an ongoing role after the transition, perhaps in an advisory capacity, to ensure that the plan is carried out smoothly and in accordance with your objectives.

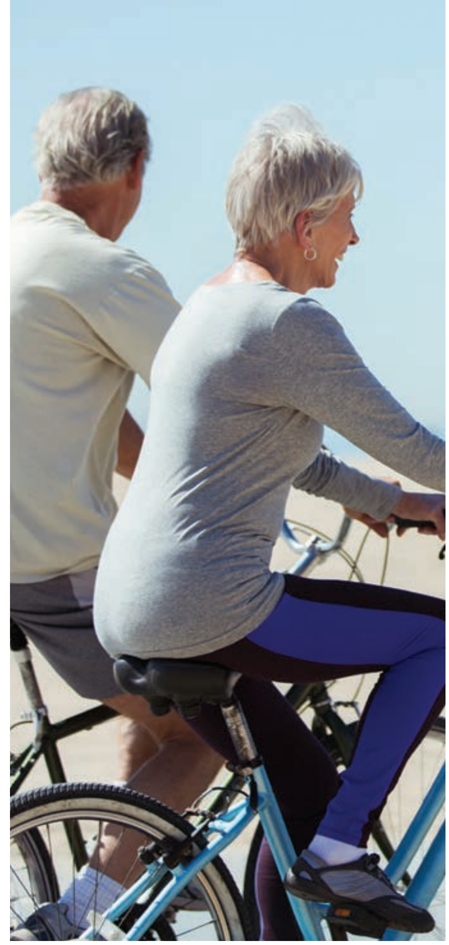
Conflict in a family business is expected, but if you can avoid the obvious pitfalls, communicate regularly, resolve issues in a timely manner and establish a clear process for managing conflict, this will help to increase the likelihood of keeping your business in the family and having it run harmoniously and successfully.

Reference:

1. Government of Canada Publications. BDC Study. *"The coming wave of business transitions in Canada."* http://publications.gc.ca/site/archivee-archived.html?url=http://publications.gc.ca/collections/collection_2017/bdc/Iu134-1-4-2017-eng.pdf

You have a business plan.

What's your retirement plan?



A family-owned business often represents more than half the value of the owner's estate. Consequently, if much of your net worth is tied up in the business, you may not be as well-diversified as those who have a more traditional retirement portfolio. Remember that unlike a salaried employee, it's up to you to fund your own retirement. Do you have a strategy? Are you relying on being able to sell your business for a sum that will enable you to enjoy a financially secure retirement? If you haven't given further thought to that "far-off" day, it may be time to consider some other options for building your retirement nest egg.

Prashant Patel, VP, High Net Worth Planning Services, RBC Wealth Management Services, says many owners overestimate the value of their business. "You have to prepare for the worst," he says. "It may take longer to sell or to transfer the business to management or family, and being over-weighted in reliance on the business for future retirement income is equivalent to someone betting their entire retirement on one stock," Patel says.

Holding some of your retirement savings outside of the business can reduce your risk. If you withdraw profits, this may protect them from future business losses. By paying yourself a salary, in addition to or instead of taking dividends, you can create an opportunity to benefit from generating Registered Retirement Savings Plan (RRSP) contribution room or Individual Pension Plan (IPP) pensionable service.

IPPs have been available for many years; however, for quite some time, they were not commonly used in practice due to high administration costs and low pension limits. Now, IPPs are offered at a much lower cost and the government has increased the limits for tax-sheltered pensions. Additionally, with recent tax changes related to the clawback of the Small Business Deduction for high passive investment income in a corporation, an IPP can help to minimize this clawback since income earned in an IPP grows tax-deferred. The combination of these factors has sparked renewed interest in IPPs.

The Individual Pension Plan is designed to reduce uncertainty about your future income by paying you a steady stream of income upon retirement.

An IPP is a registered pension plan, similar to those offered by large organizations to their employees. However, an IPP usually only has one individual member — either the business owner or a key employee. It can also be extended to your spouse, if he or she is employed by the same company.

Although there is no minimum age or income level to set up an IPP, typically those earning a T4 salary of more than about $148,000 in 2018 (updated annually based upon new limits on certain factors set by the government and used in the formula to calculate this limit) and age 40 or older tend to reap the most benefit from this retirement saving option.

Higher contributions

Your business or employer makes annual contributions to the IPP over time and receives a tax deduction. The corporation's IPP contributions replace your contributions to an RRSP. Similarly to an RRSP, contributions grow in the IPP on a tax-deferred basis. Since an IPP is designed to give you a defined amount of income at retirement, the older you are, the more money the company can contribute to the plan on your behalf.

Contributions will also vary depending on your past earnings and length of service with the company. The plan is designed to reduce uncertainty about your future income by paying you a steady stream of income upon retirement.

In addition to annual contributions, your business can potentially make a large contribution when the plan is initially set up to cover your previous years of service prior to the IPP being established, going back as far as 1991. Additional tax-deductible contributions may also be made to the IPP to make up for investment returns in the plan that are less than the 7.5 percent expected actuarial interest rate with inflation adjustments (in some provinces this is a requirement).

Creditor protection

RRSP assets are generally only protected from creditors in the case of personal bankruptcy. That means that for the vast majority of business owners and incorporated professionals, RRSP assets remain at risk. Because it is a trusteed arrangement and a pension, an IPP may afford substantial protection from creditors. It is essential that you speak to a qualified legal advisor regarding any asset protection options available to you.

Locked-in funds

As the IPP is a registered pension plan, the funds in the plan are locked in both during your working years and in retirement under provincial legislation (with exceptions in certain provinces). This means there is less flexibility compared to an RRSP when it comes to withdrawals from the IPP.

You can receive income payments directly from an IPP, or transfer some of the IPP's funds, within legislated limits, to a locked-in plan. Some provinces allow additional pension income flexibility by unlocking the funds in special circumstances.

Administrative costs

IPPs come with higher administrative costs compared to an RRSP. There are set-up costs, annual administration fees and mandatory actuarial valuations. These costs, however, are tax-deductible to your business, reducing the effective cost.

Note: The information provided is a selection of potential options to consider. As part of overall planning, it is important to speak with your qualified tax and legal advisors to determine whether these, or other, strategies may be suitable and to ensure your personal circumstances and goals are appropriately accounted for.

There are many intricacies to IPPs, so it is imperative to understand all of the details. Ultimately, for the right person, IPPs can offer significant advantages — creditor-protecting assets today and greater retirement income in the future.

PROTECT YOUR HUMAN CAPITAL WITH KEY PERSON INSURANCE

As a business owner, it's not uncommon to rely on a few key people for the successful operation of your company. In fact, many businesses are built around the strengths and skills of a handful of individuals whose capital, energy, knowledge or experience makes them valuable assets to the organization. But, while most business owners understand the need to protect against unforeseeable risks such as fire and theft related to their capital assets, risks related to human capital within their organization are often overlooked.

Human capital risks refer to the temporary or permanent loss of key employees due to illness or death. Similar to a loss of capital assets, such a loss can also threaten the viability of a business.

How would your business be impacted if one of the partners or key employees — a manager, top sales person or technical specialist, for instance — passed away or became unable to work? Would you have sufficient cash on hand to deal with the temporary business emergency? In many cases, the answer to these and other questions about risk is "no".

The potential risks to a business are significant

- Business performance may lag due to the absence of the individual.
- Costs to find a suitable replacement for that individual may escalate.
- Creditors may restrict or withdraw credit.
- Suppliers may tighten payment terms.
- Customers may reconsider using the business or services.

"The good news is that these risks can be managed," says Joel Cuperfain, Estate Planning Specialist with RBC Wealth Management Financial Services. "Every business needs a contingency plan that involves insurance protection to help minimize the impact on the business of losing a key member of the organization, whether it's a temporary or permanent loss."

Key person insurance can alleviate some of these risks

- It lets you transfer some of the business' risk to the insurer.
- The cost is limited to the premiums paid for the insurance policies.
- The expenses resulting from the loss of a key person may be offset and more predictable.
- There can be significant tax savings through tax-free growth.
- The risk and costs to the business resulting from the premature death or illness of valuable employees is reduced by providing capital for training, replacement or to meet financial objectives.

How does it work?

Typically, the business is the owner, the premium payer and the beneficiary of key person life insurance. Premiums are generally not deductible; however, if the insurance coverage is a requirement by a lender as collateral for the debt and certain other income tax requirements are met, the company may be able to deduct a portion of the premium. In addition, note that the death benefit of the insurance policy will be received tax-free by the company. Keep in mind that since this solution uses life insurance, the key person would also have to qualify for the insurance coverage. "Most businesses need time and capital to replace a key person," says Cuperfain. "Key person insurance can be a cost-effective way to help ensure the ongoing operation and continued success of your business."

There are three types of insurance that are often used to provide key person protection:

(Note: The following provides a selection of potential options to consider. To ensure options are best suited to your business needs and goals, it is important to consult with qualified tax, legal and estate planning professionals.)

1 Key person life insurance

Life insurance is usually the cornerstone of a key person protection strategy. It provides an injection of tax-free capital into the business upon the death of the key person. Life insurance may be a source of low-cost funding in the event of a key person loss; it can also be used to fund buy-sell agreements and may offer considerable flexibility in how an arrangement is structured.

2 Key person disability insurance

Disability insurance can be used for two purposes. One, the insurance can provide salary continuation to the key person in the event that he or she becomes disabled, usually until the earlier of age 65 or recovery from the disability. Two, the owner/manager can purchase insurance that provides continued payment of office expenses and salaries during the period of disability, usually for a limited time period.

3 Key person critical illness insurance

This type of insurance provides protection in a situation where a key person is afflicted by specified diseases or health problems that do not necessarily render that person disabled, but nevertheless affects his or her productivity or desire to work to the same extent as before. This coverage will generally pay a lump sum to help cover losses created by the individual's absence or lower productivity.

Making sure you have adequate business insurance, regardless of the kind of asset you are insuring — capital or human — provides peace of mind in the short term and can help to ensure your business' continued success in the long term.

8 Shareholders' agreements – essential questions

When several parties are working together in a business, whether as a partnership, incorporated company or any other type of formal business venture, the parties can enter into a contractual agreement that would govern their relationship. In the case of a corporation, this contract would be referred to as a shareholders' agreement. While it is not mandatory to have a shareholders' agreement, it can streamline the management of the business and provide guidance to shareholders at specific points during the lifetime of the business.

A shareholders' agreement is intended to deal with potential risks and events that may arise over the course of the business relationship. Provisions can be included to recognize the relationship between shareholders, their families, other legal entities, and the corporation itself. The following list, although not exhaustive, outlines certain questions that you should ask yourself when drafting or revising a shareholders' agreement.

Note: In creating or making changes to a shareholder's agreement, it is crucial to consult with qualified tax and legal advisors to ensure that options and considerations have been appropriately addressed, that your individual situation has been accounted for and that all information has been properly documented.

Make sure you have sufficient life and disability insurance to cover the redemption of shares from each shareholder in the event of their death or long-term disability.

1

Have you made any changes to the corporate structure?

Making a revision to the shareholders' agreement following a corporate reorganization, such as an estate freeze, or even the addition or withdrawal of a shareholder, should not be overlooked. Make sure your shareholders' agreement properly reflects your corporate structure to avoid any unforeseen issues.

2

When did you last determine the value of the business?

Oftentimes, shareholders of private corporations have a good idea of their company's value. However, there are numerous circumstances that will require a formal determination of fair market value to be calculated by a professional business valuator, such as the sale of shares by a shareholder. Since there are numerous methods of calculating the corporation's fair market value, the shareholders' agreement should specify the preferred valuation method agreed to by all shareholders.

Having the valuation method pointed out in the shareholders' agreement will help to avoid any conflicts when one shareholder is looking to enforce the agreement for the purpose of redeeming their shares or purchasing the shares of another shareholder. Furthermore, it may be prudent to include a dispute resolution plan if shareholders disagree over the final valuations.

To avoid revising the entire agreement each time the value of the business is adjusted, an appendix to the agreement can be used. A price adjustment provision may also be included to allow the value to be adjusted upward or downward, should the tax authorities disagree after the fact.

3

Have you considered shareholder illness or death?

In cases of severe illness, such as incapacity, or death of a shareholder, a share redemption clause can provide guidance as to how that shareholder's shares will be dealt with. The redemption clauses and mechanisms may vary considerably from one agreement to the next. In some cases, the redemption clause will allow other shareholders to purchase the former shareholder's shares. In other cases, the corporation will buy back the shares. The ultimate goal of a redemption clause is for the existing shareholders to maintain control of the shares while paying the former shareholder fair market value for the shares.

It is important for each shareholder to make sure their estate plans are drafted in keeping with the redemption clause in their shareholders' agreement. For example, a redemption clause will prevent a shareholder from leaving his or her shares to heirs.

4

Are the redemption clauses funded?

Share redemption clauses in the event of disability or death should go hand in hand with the method and source of funding, such as life insurance, disability insurance, the company's liquidity, the company's borrowing capacity or even the borrowing capacity of other shareholders. Insurance is often the simplest way to exercise these agreement clauses, but in certain circumstances, other sources will be used.

Make sure you have sufficient life and disability insurance to cover the redemption of shares from each shareholder in the event of their death or long-term disability. In the absence of insurance, the agreement should provide for payment terms for the value of the shares by the company or the other shareholders.

5

Could your agreement benefit from the grandfathering provisions related to the stop-loss rule?[1]

Prior to February 26, 1995, a shareholders' agreement funded with life insurance benefitted from an undeniable advantage compared with the tax rules in force today. Previously, taxes on the redemption of shares from a deceased shareholder could be significantly reduced, even eliminated, by funding the redemption of shares using the proceeds of life insurance. Since February 26, 1995, new rules have, in part, limited the tax advantage of redeeming shares with life insurance.

However, tax authorities have introduced "grandfathering provisions" for individuals who have a shareholders' agreement that was written before February 26, 1995. In general, grandfathering provisions will apply in the following cases:

- Where life insurance was in place before February 26, 1995, and it can be concluded that the main purpose of the life insurance policy was to fund the redemption of shares by the corporation in the event of a shareholder's death; or
- Where a shareholders' agreement existed before February 26, 1995, and the redemption of shares by the corporation was planned in the event of a shareholder's death.

If the agreement benefits from the grandfathering provisions, it may be difficult to amend it without losing the benefits conferred. Therefore, if the corporation existed before February 26, 1995, make sure you consult an expert before making any changes to your shareholders' agreement. In case of doubt and when possible, it may be preferable to draft a separate document to complement the original agreement.

6

Does your shareholders' agreement consider tax opportunities and restrictions?

A shareholders' agreement should allow sufficient flexibility to take advantage of the tax laws at the time the provisions within the agreement are applied. For example, where funds need to be distributed to shareholders, the choice of the type of income to be distributed can make a difference.

The following is a list of a few tax considerations not to be overlooked when drafting a shareholders' agreement:

- The citizenship of the shareholders and beneficiaries of a shareholder trust, notably U.S. citizenship.
- The tax residence of shareholders and beneficiaries of a shareholder trust.
- Family relationships, within the meaning of the Income Tax Act, between shareholders, including beneficiaries of a shareholder trust.
- Where life insurance is used for the purpose of redeeming shares, define how the capital dividend account will be used. For instance, should the surviving shareholders or the deceased shareholder's estate be favoured.
- Ideally, as previously mentioned, the drafting of share redemption clauses should attempt to minimize the impact of the application of the stop-loss rules.

As tax rules are constantly evolving, certain clauses may include some flexibility for the surviving shareholders and estate representative to ensure that the tax rules in force at the time of death can be optimized.

7

What about your personal planning strategy?

The shareholders' agreement is merely a document that governs the relationship between shareholders in the light of certain events. However, this agreement will not settle the distribution of an estate or the way in which a shareholder's wealth is managed should the latter be unfit to manage it himself or herself.

It is important that each shareholder, as well as his or her spouse, review their personal planning and legal documents, including their Wills and Powers of Attorney, with the help of a qualified legal professional. These documents should be revised, as necessary, based on the relevant provisions contained in the shareholders' agreement.

While these points provide a solid starting point for revising and updating a shareholders' agreement, it's important to consult qualified tax and legal experts who specialize in the preparation of such documents. A well-drafted shareholders' agreement

A shareholders' agreement should allow sufficient flexibility to take advantage of the tax laws at the time the provisions are applied.

will take into consideration the economic, legal and personal reality of each shareholder, as well as the specifics of the business itself.

8

Does the company have a contingency plan?

Although a contingency plan does not constitute part of the shareholders' agreement, it's still worthwhile to consider preparing such a plan at the same time as your shareholders' agreement, and ensuring that everyone involved is aware of the contingency plan.

A contingency plan addresses the company's operations in the face of an emergency involving the management of the corporation. Whereas a shareholders' agreement covers transactions between shareholders, a contingency plan defines the actions to be taken by the management team to ensure the continuity of operations in situations requiring quick decisions that cannot be taken by the officer, for instance, in the event of his or her death or disability.

In an emergency situation, it is essential to have resources readily available in order to act quickly and reassure customers, creditors, employees and shareholders. For instance, it may be necessary to have life insurance protection for key employees and officers, strictly with a view to maintaining business operations.

Having a well-defined contingency plan for extreme circumstances, and implementing it when necessary, will help to reduce uncertainty and stress if a key person in your company is not available.

Note:
[1] The rule generally applies to limit the capital loss an estate might incur following the redemption of shares from a private corporation, if more than 50 percent of the dividends used for the redemption of shares were tax-free capital dividends. Subsection 112(3) of the Income Tax Act.

MINIMIZE tax and **MAXIMIZE** your business sale

There is a myriad of reasons for deciding to sell your business — from retirement, to a new business opportunity, to an unsolicited offer. Whatever your reason for selling, it's important to realize that the tax payable on the sale could be the largest one-time expense you will ever have to pay. Assuming you are planning an external sale and not transferring or selling the business to family members or management, there are a number of Canadian tax strategies you can consider. If you are a U.S. person, you should consult a qualified cross-border tax advisor to determine the U.S. tax implications of the following strategies.

Consider the following tax-planning strategies, relevant to each of the four time periods associated with selling a business.

Note: Given the complexity of the following planning considerations, it is crucial to ensure your needs and circumstances have been properly accounted for by consulting with qualified tax and legal professionals.

Four time periods to consider for sale of business tax planning:

- Running an active business and not planning to sell
- Pending sale
- Year of sale
- Post year of sale

STAGE 1

Running an active business and not planning to sell

If a sale is not imminent and you expect the value of the business to increase, then consider reorganizing the share ownership of your company such that some or all of the future capital gains of your business can accrue to other family member shareholders, either directly or through a family trust. This is commonly achieved by implementing an "estate freeze." This strategy can allow for a multiplication of the lifetime capital gains exemption (LCGE) among family members on a future share sale of a qualifying small business corporation (QSBC). Every person has a lifetime LCGE on the sale of QSBC shares. To qualify, the family member must own the QSBC shares either directly or be a beneficiary of a family trust that owns the shares. The LCGE on the sale of QSBC shares is $848,252 for 2018 and indexed annually.

If shares are issued from treasury to family members or to a family trust, then the shares must be held for at least two years to qualify as QSBC shares and hence the LCGE, so advance planning in this case is important.

Other criteria that needs to be met in order to qualify for QSBC status are that throughout the 24-month period prior to the sale, at least 50 percent of the assets in the business must be used to carry on an active business in Canada, and at the time of sale, at least 90 percent of the assets must be used in the active business in Canada. If you have accumulated passive investment assets in your company, there may be strategies you can employ to restructure your business so the passive assets do not disqualify your shares from QSBC status and prevent you from claiming the maximum LCGE. It is easier to restructure your business in a tax-effective manner when there is no pending sale, so again, advance planning is important.

When reorganizing the structure of your business to qualify for the LCGE and also to multiply the LCGE with other family members, speak to your tax advisor to determine if you should "crystallize" your LCGE now. That is, even if you are not currently selling your business to a third party, some tax advisors may recommend that you crystallize your LCGE now, while the shares are QSBC shares, to avoid any concerns that the shares may not qualify for the exemption at some point in the future. However, depending on your situation, it may not be appropriate to crystallize the LCGE now, so investigate the pros and cons.

STAGE 2

Pending sale *(in negotiation with potential purchaser)*

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 your LCGE. In this case, the shares do not have to be held for at least two years to qualify for the LCGE.

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 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.

There are some more sophisticated tax strategies that may allow you to claim both the LCGE for part of the proceeds as a QSBC share sale and treat the remaining proceeds as an asset sale.

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 LCGE. As previously mentioned, if there are passive assets in the corporation such that less than 90 percent of assets are being used in active business, your tax advisor may have to restructure or "purify" the business assets 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.

In addition to claiming the LCGE 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 currently at capital gains tax rates. This strategy is called a "safe-income strip." You will need to speak to your tax advisor to determine if this strategy is available to you.

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

Also consider having your 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.

STAGE 3

Year of sale

You may want to think about using some of the sale proceeds to make a charitable gift in the year of sale either directly to a registered charity or to your own charitable foundation. In order for this strategy to be effective, the charitable donation should be made before the end of the year in which the sale occurs (either December 31 in the case of an individual vendor or the fiscal year-end of the corporation for a corporate vendor). Since the donation is irrevocable, ensure that you have adequate other assets to meet your retirement income and estate planning goals. A financial plan can help in this regard.

Alternatively, if the purchaser is a Canadian public company, consider receiving some shares of the Canadian public company as part of the sale proceeds (these shares may be received on a rollover basis). The shares could then be donated in-kind to eliminate the capital gains tax relating to the donated shares and you would also receive a donation tax receipt equal to the market value of the stock donated, which can help reduce the tax on your cash proceeds.

In some cases, you may want to look at the pros and cons of setting up an Individual Pension Plan (IPP) or a Retirement Compensation Arrangement (RCA) in the year of sale, if you have not done that already. If the sale is structured as an asset sale, then the employer's contribution to these retirement plans is considered a deduction to the corporation, which would reduce the corporate tax payable. Note that a more detailed analysis of the pros and cons of this should be performed given that income received from an IPP or an RCA in retirement is taxed as regular income. In comparison, tax payable today on an asset sale may be at lower tax rates (e.g. capital gain).

If you have publicly traded securities that are in a capital loss position, consider selling these loss securities prior to year-end to trigger the capital loss. This may help to reduce the capital gain on the sale of the business. This decision should be made based on investment merits as well. If you want to repurchase the stock, then you may want to wait 30 days to avoid the loss being disallowed under the "superficial loss" rules.

Another option might be to purchase flow-through shares prior to year-end to help reduce the tax relating to the sale of the business. Flow-through shares are resource-based investments where the government allows the purchase cost to be fully deducted against any other taxable income. However, the investments are more speculative in nature. Also, keep in mind that in some cases, there is an 18- to 24-month holding period.

Alternative Minimum Tax (AMT) may also apply on large personal flow-through purchases, so this should be discussed with your tax advisor before making a purchase.

Instead of receiving all of 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.

STAGE 4

Post year of sale

If you expect to reinvest some or all of the sale proceeds in shares of another active Canadian business within 120 days after the year of sale, then you may be able to defer the recognition of some or all of the capital gain on the original sale.

Or, if you have publicly traded securities that are in a capital loss position, you could consider selling these loss securities prior to year-end to trigger the capital loss. If your current year capital losses exceed your current year capital gain, then the net capital loss can be carried back to offset capital gains in the prior three years. So, if you sold your business in 2018, then net capital losses in 2019, 2020 or 2021 can be carried back to 2018 to reduce the capital gain on the sale of your business and you would get a refund of some of the tax you paid in 2018 on the sale. This decision should be made based on investment merits and you should also bear in mind the 30-day superficial loss rules if you want to repurchase the security that was sold at a loss.

If you are going to work for the purchaser after the sale to assist with the transition, speak to your tax advisor to determine the best structure in which you should receive your compensation going forward — as an employee of the new corporation or a consultant.

Also, work with a qualified investment professional to manage your sale proceeds to create adequate retirement income to meet your lifestyle needs. Depending on your age, life annuities may be appropriate for a portion of your sale proceeds to guarantee monthly income for life.

You may also want to consider permanent life insurance to replenish any capital for the estate that was used to purchase a life annuity. This can also be a way to grow any surplus wealth that was realized from the sale in a tax-efficient manner to enhance your estate. If some of the sale proceeds are in a holding company, then life insurance can enable your beneficiaries to withdraw insurance proceeds from the holding company on a tax-free basis.

Lastly, don't forget to talk to your legal advisor to determine if your Will may need an update in light of these changes.

Depending on your age, life annuities may be appropriate for a portion of your sale proceeds to guarantee monthly income for life.

Safeguard the continuity of your business

> A comprehensive estate plan should contemplate not only the distribution of your assets on your death, but also which individuals or organizations would make decisions on your behalf, from both a personal and financial perspective, if you couldn't.
>
> **Abby Kassar,**
> Vice President, High Net Worth Planning Services, RBC Wealth Management Services

While running a business is rewarding, it can also be time-consuming, demanding and challenging. Have you considered who would take on your business responsibilities if you were suddenly unable to do so? Who would manage your business in your absence?

Although it's easy to get wrapped up in the ongoing operation of a business, you also need to make sure you have a current estate plan that takes your business interests into account.

"It's critical to think about how your business would continue to operate if you were incapacitated," explains Abby Kassar, Vice President, High Net Worth Planning Services, RBC Wealth Management Services. "A comprehensive estate plan should contemplate not only the distribution of your assets on your death, but also which individuals or organizations would make decisions on your behalf, from both a personal and financial perspective, if you couldn't."

Power of Attorney

You can achieve this kind of planning using a Power of Attorney. There are generally two kinds of Power of Attorney — a Power of Attorney for property and a Power of Attorney for personal care. Depending on the province or territory where you live, other healthcare directives and instructions for your personal care may be available. For instance, if you live in Quebec, you would prepare a Mandate instead of a Power of Attorney. Consult with a qualified legal advisor about the documentation you may need for your particular area and circumstances.

"It's not uncommon to procrastinate when considering subjects such as death or incapacity, but a properly prepared Power of Attorney can help ensure not only that your personal and financial decisions are handled appropriately, but also that your business continues to run smoothly," says Kassar. "This can be important whether you are the sole proprietor of an unincorporated business, a partner in a partnership or an owner or a director of an incorporated company."

Who should you appoint as your attorney?

When choosing an attorney, the most important criterion is always to choose an individual who will prioritize your best interests. When you own and operate a private corporation, you should also consider who would be appropriate to take control of your corporation. It is possible to appoint a single attorney or multiple attorneys to work together. Consider appointing an individual or individuals to act on your behalf who understand your business and could work co-operatively with existing directors, shareholders, partners, employees or other staff members who may be involved in day-to-day decision-making.

The right choice can be critical to avoiding disruption in your business and minimizing the impact on your customers.

Other factors also need to be considered. Who would be a good alternate attorney if your primary attorney was unable to fulfill his or her duties? Should you compensate your attorney, and if so, how much? Can your attorney delegate his or her authority? Discuss these questions with your qualified legal advisor and, if appropriate, involve key individuals in your business to keep everyone informed of your decisions.

When will your Power of Attorney come into effect?

Consider the range of tasks that would require attention in order to operate your business and manage your affairs if you were unable to take care of them yourself. Aside from using a Power of Attorney in the event of your physical or mental incapacity, you can also choose to have this document take effect in various other situations. Donors have the ability to control the range of authority given to their attorney, as well as when that power is to take effect and for how long. For example, you may wish to have your attorney act in limited circumstances on your behalf while you are away on business or vacation and cannot act personally. The power you give could be limited to one specific absence. You could also choose to have the Power of Attorney take permanent effect if you become incapacitated, as it may be impractical or impossible for you to manage your affairs in the usual way.

If you want your Power of Attorney for property to remain valid during a period of incapacity, the Power of Attorney you prepare must contain a clause that the power granted to the attorney will continue notwithstanding the donor's loss of mental capacity. This is known as an "Enduring" or "Continuing" Power of Attorney. If you don't have such a clause, the power you grant to your attorney will cease if you lose mental capacity. This can be precisely the time when you need an effective Power of Attorney.

> When granting a Power of Attorney, you should try to anticipate what issues your attorney may encounter and you may want to give direction as to how to deal with these issues.

Another option is to provide that your Power of Attorney will not become effective until you are mentally incapable of managing your finances. If you wish to have the Power of Attorney take effect in such a case, ensure your lawyer is aware of your intention and clearly defines what the triggering event will be. In cases where the document comes into effect on your mental incapacity, consider instructing your lawyer to identify in the Power of Attorney the person or organization responsible for determining your competence and perhaps stipulate an appropriate dispute resolution mechanism in case a conflict or disagreement arises.

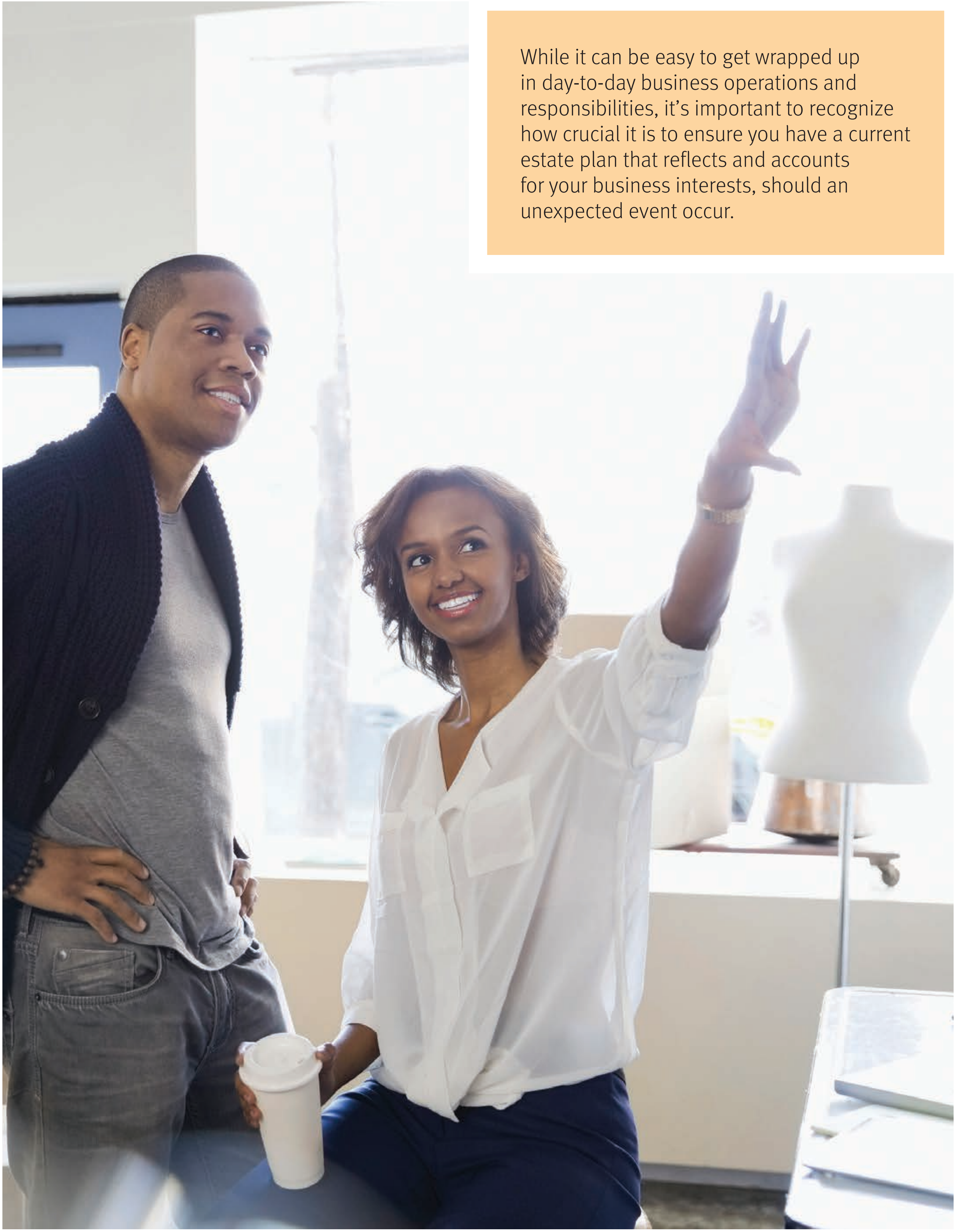
What powers will you give your attorney?

When granting a Power of Attorney, you should try to anticipate what issues your attorney may encounter and you may want to give direction as to how to deal with these issues. You can be as broad or as specific as you wish. Remember that your attorney must always adhere to the fundamental principle that he or she is acting in a fiduciary capacity and his or her actions must be in your best interests. Other common law principles also apply to the fiduciary relationship that exists between you and your attorney. These are implied by law and do not need to be expressly included in the Power of Attorney. For example, the common law requires that the attorney avoids conflicts of interest and acts in good faith. Bear this in mind when deciding the terms on which to grant a Power of Attorney and the contingencies for which you wish to empower your attorney.

When thinking about your personal assets, if you want your attorney to have the ability and authority to perform any of the following tasks, you generally need to include an express provision in the document that authorizes them to:

- Delegate investment powers to a portfolio manager or investment counsellor;
- Make gifts or loans to third parties, including charities;
- Implement estate planning strategies such as settling an inter vivos trust, effect an estate freeze and transfer assets in your sole name to a joint account with right of survivorship; and

While it can be easy to get wrapped up in day-to-day business operations and responsibilities, it's important to recognize how crucial it is to ensure you have a current estate plan that reflects and accounts for your business interests, should an unexpected event occur.



- Make certain beneficiary designations on RRSPs, RRIFs, TFSAs and/or insurance policies.

On the other hand, when thinking about your private corporation shares and the management of your corporation, there are additional matters to consider. A couple of significant considerations are discussed in the following sections.

Acting as a company director

Using a Power of Attorney may not be sufficient for your attorney to conduct transactions on non-personal accounts. Typically, corporate accounts can only be accessed by representatives of the corporation, such as an officer or director. When you appoint an attorney, you are authorizing that person or organization to step into your shoes as the owner of your shares and sell, transfer or vote on the shares on your behalf. The Power of Attorney does not give your attorney authority to act as a director of your corporation.

To become a director, your attorney, in his or her capacity as a shareholder under the Power of Attorney, would need to elect himself or herself as director. So if you are a company director, consider this additional step and ensure that your attorney will have the power he or she needs to fulfill the duties you intend for him or her. If there are other corporate shareholders, your attorney may also need their consent to be elected as a director. By planning ahead and informing everyone who is likely to be affected, you can equip your attorney with the powers necessary to act.

If you wish your attorney to perform transactions on your behalf on your non-personal accounts, consult your qualified legal advisor regarding the documentation that may be required.

Does your attorney have a corporation?

If you give your attorney broad powers, including the ability to exercise voting rights over your corporate shareholding, Canada Revenue Agency (CRA) may deem that your attorney is the owner of the shares unless the exercise of the voting rights is contingent on your death, bankruptcy or permanent disability.

CRA has held that where you give your attorney the authority to vote shares of a corporation legally controlled by you, your corporation would become associated with any corporation controlled by your attorney. This association of two corporations may have unintended tax consequences. The two corporations may then be required to share the small business deduction limit and this can reduce the tax benefit from which each of the corporations could have benefitted. When including powers in your Power of Attorney, ensure that by appointing the attorney you have chosen, you are not inadvertently associating your corporation with a corporation controlled by your attorney. To minimize the chance of this happening, provide in the document that the Power of Attorney will only take effect in the event that you are permanently disabled.

Note: In the creation or update of a Power of Attorney, it is important to consult with a qualified legal advisor to ensure your wishes and intentions are properly accounted for and that all information is accurately documented.

> “It’s not uncommon to procrastinate when considering subjects such as death or incapacity, but a properly prepared Power of Attorney can help ensure not only that your personal and financial decisions are handled appropriately, but also that your business continues to run smoothly.”

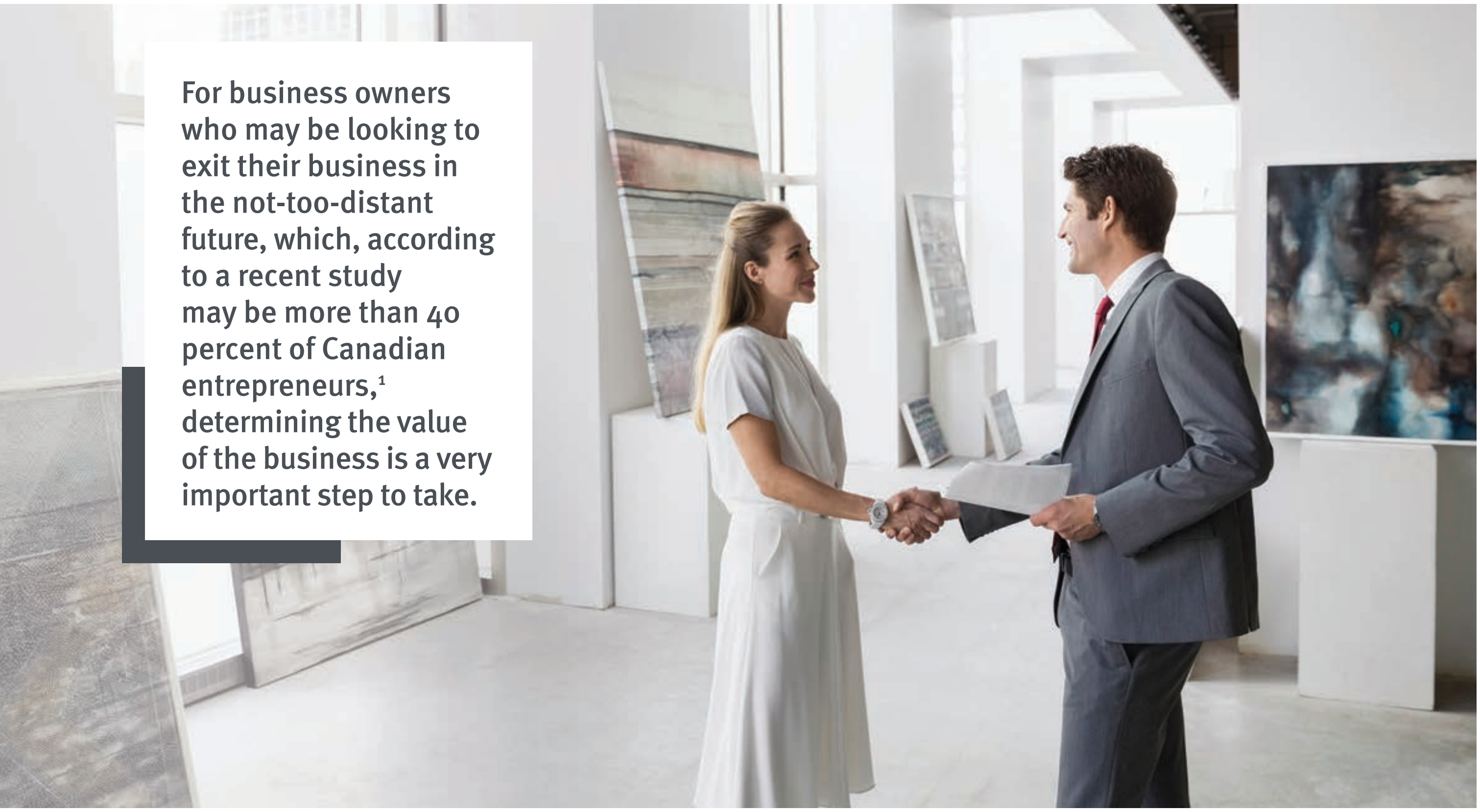
WHAT'S YOUR BUSINESS WORTH?

Methods for determining the value of your business and why it's an important process.

For business owners who may be looking to exit their business in the not-too-distant future, which, according to a recent study may be more than 40 percent of Canadian entrepreneurs,[1] determining the value of the business is a very important step to take. And while this holds especially true for owners who may be planning their retirement and who intend to sell their business to provide a source of funds, having a clear idea of your company's value is crucial in other situations as well (for example, if undertaking an estate freeze).

When it comes to accurately assessing business value, a beneficial option to consider is the services of a valuation specialist. When valuing a business, valuation specialists generally calculate the fair market value. This is the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between informed and prudent parties, acting at arm's length and under no compulsion to transact. However, there is no single standard or specific mathematical formula that can be consistently applied to value a business. The particular approach and the factors to consider will vary in each case. In the valuation of privately-owned businesses, there are three generally accepted methods: an asset-based valuation approach, an income-based approach and a market-based approach.

Note: The following information provides an overview of business valuation approaches. Given that every business situation and structure is unique, it is crucial to consult with your qualified advisors and tax and legal professionals to ensure your circumstances and needs are appropriately addressed and that the most suitable process is undertaken to accurately determine the fair value of your business.



For business owners who may be looking to exit their business in the not-too-distant future, which, according to a recent study may be more than 40 percent of Canadian entrepreneurs,[1] determining the value of the business is a very important step to take.

Asset-based approach

The asset-based approach, which involves calculating the value of a business based solely on the value of its net assets, is generally utilized in the following situations:

- When the value of a business is closely related to the value of its underlying assets, as in the case of an investment company or a real estate holding company;
- When the assets of a business are not generating adequate returns the way they are currently being used, as in the case of a business generating nominal earnings, and their value could be maximized by some other use or by their sale; and
- Where the value of the business is attributable to the current owner's personal attributes or relationships and is not transferable to a new owner. For example, if the relationship between the customers and the company are unlikely to continue should the current owner not be involved in the business.

Using this approach and assuming the business is viable, the fair market value of all the assets and liabilities of the business is determined. Generally, when determining this, a valuator would consider the following:

- Whether a write-down of any accounts receivable is required to reflect any potential bad debts;
- Whether the inventory on hand could be sold for an amount higher or lower than its book value;
- Whether an appraisal from a specialist is required to determine the fair market value of certain assets such as real estate or machinery and equipment; and
- The potential disposition costs associated with the assets and liabilities. For example, consider not only the fair market value of a real estate property, but also any costs associated with its sale, such as legal fees, commissions and taxes. A potential purchaser would likely require a discount on the purchase price to reflect these costs.

The net amount of the fair market values of the assets and liabilities represents the fair market value of the common shares of the business under this approach.

Income-based approach

An income-based approach is appropriate where the business being valued is generating an adequate return on its capital and a theoretical purchaser is interested in acquiring the business' future earnings or cash flows. This approach is appropriate where the earning power of a business is greater than the value of the individual assets owned by it. The capitalized earnings approach, capitalized cash flow approach and discounted cash flow approach are various income-based approaches that can be used to value a business.

We'll focus on the capitalized earnings approach, as this is appropriate for a mature, established business. This kind of business would not need to invest in major capital assets and its future earnings are generally predictable and can be reasonably estimated.

To determine the value of a business using this approach, the expected annual future earnings of the business, or its maintainable earnings, should be calculated. The business' historical financial results can provide an indication of this. However, you may need to adjust the historical earnings to eliminate the impact of any nonrecurring or uneconomical items. Some common examples of these include:

- Compensation, including salaries and any personal benefits, paid to non-arm's length individuals who are either above or below the economic compensation levels for the position. For example, assume an owner and manager of a business receives a salary of $400,000 a year, while industry research reports indicate the salary for a CEO of a similar business is $250,000. As a result, $150,000 would be added to income when determining maintainable earnings; and
- Gains or losses earned in a year that are unlikely to recur in the future, such as a gain or loss from a one-time sale of an asset.

The maintainable earnings are then multiplied by an earnings multiple. This multiple is the inverse of the rate of return required by a theoretical purchaser on his or her investment in the business. For example, a purchaser requiring a return of 20 percent on his or her investment would multiply the maintainable earnings figure by 5 (1/20% = 5) to calculate the value of the business. Note that the rate of return a theoretical purchaser will require changes over time and according to the situation and will reflect the risk of the particular investment being analyzed. A theoretical purchaser would likely consider the following risks:

- Nature and history of the business
- Customer base
- Management team and employee experience and qualifications
- Financial position
- Ease or difficulty of entering the industry, including any regulations
- Industry trends and challenges
- Economic and financial conditions
- Competition
- Current rates of return on alternative investments, including the risk-free rate

There are several methods that can be used to determine the appropriate rate of return to value a business. The weighted average cost of capital (WACC) is the method that is typically used. The WACC is the rate of return determined by the weighted average cost of debt and return on equity. A valuation specialist usually assists with this determination. When the WACC has been determined, the inverse of the WACC is the multiple used to value the business.

The maintainable earnings are multiplied by the multiple to calculate the enterprise value. The enterprise value represents the fair market value of the net assets used in ongoing operations (known as the tangible asset backing) and the value of the goodwill that can be transferred to a potential purchaser (known as the commercial goodwill). The fair market value of any assets owned by the business that are not employed and required in its day-to-day operations, known as redundant assets (such as excess cash or short-term investments, etc.) is then added to this value. As these assets are not required for business operations, it is assumed that an owner would either extract such redundant assets from the business prior to a sale (i.e. through a dividend or corporate restructure) or require compensation from the purchaser for the fair market value of these redundant assets.

The total of the enterprise value and the fair market value of the redundant assets represents the value of the business as a whole. The value of all outstanding interest-bearing debt is subtracted from this amount to determine the fair market value of the common shares of the business.[2]

Market-based approach

The market-based approach is the most commonly used approach in a sale of a business. It uses data regarding the market valuation of public and other private companies that are reasonably comparable to the business being valued. Comparable companies are those which operate in a similar industry and region as the business being valued and, when possible, should be relatively the same size (similar revenues or number of employees, etc.). The two significantly used market-based approaches are the precedent transaction multiple approach and the public company multiple approach.

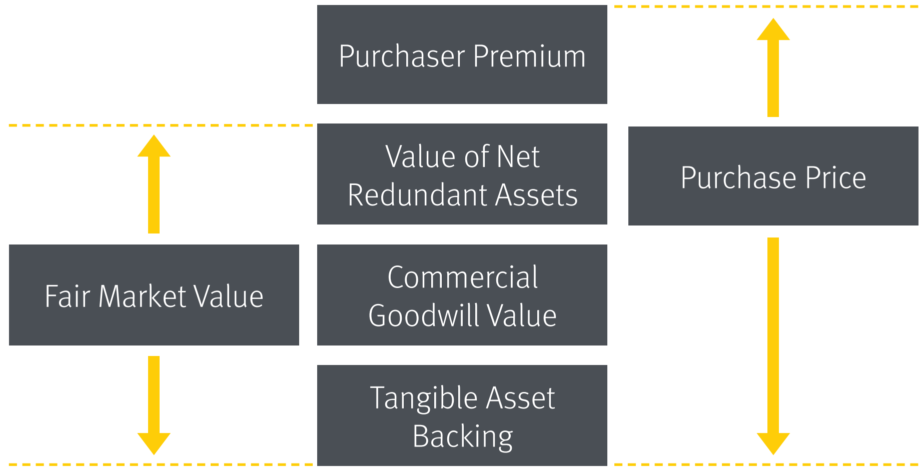
In the precedent transaction multiple approach, implied valuation multiples are derived from acquisitions of private companies that operate in the same industry as the business being valued. For example, let's assume an owner is interested in valuing her business and has identified two comparable private companies (i.e. similar industry, operating regions and size) recently purchased in two separate, independent transactions:

- 100 percent of the common shares of Company A (which has no debt), with an EBITDA[3] of $2 million, and using a multiplier of 5, was acquired for $10 million; and
- 100 percent of the common shares of Company B (which has no debt), with an EBITDA of $4 million, and using a multiplier of 4, was acquired for $16 million.

Using this data, the owner could determine the enterprise value of her business by multiplying her business' most recent maintainable EBITDA by 4.5, the average implied EBITDA multiple in the two private transactions. She would then add the fair market value of any redundant assets and subtract the value of all interest-bearing debt to determine the fair market value of the common shares of her business.

In the public company multiple approach, a business is valued based on the valuation multiples derived from the enterprise value of publicly traded comparable companies. For example, let's assume an owner is interested in valuing his business and has identified two comparable public companies, with no debt, that have the following most recent trading information:

- Company A, with annual sales of $150 million, has an enterprise value of $132 million; and
- Company B, with annual sales of $160 million, has an enterprise value of $128 million.



The average enterprise value-to-sales multiple implied in the two public companies is 0.84. As public companies are generally much larger, operate in more regions and are more diverse than private companies, it is inappropriate to value a private company using the same public company multiple, without considering a discount. In this situation, let's assume a valuator determined that a 45 percent discount is appropriate. The owner could then determine the enterprise value of his business by multiplying his business' most recent maintainable sales by 0.46, the average implied sales multiple in the two public companies, less a 45 percent discount. He would then add the fair market value of any redundant assets and subtract the value of all interest-bearing debt to determine the fair market value of the common shares of the business.

Fair market value vs. price

So now that you've determined the value of your business, does that mean you know the amount you can sell your business for? Not necessarily. In an actual sale, potential purchasers may be willing to acquire a business for a price that is different from the business' fair market value. This could be based on several factors, including the negotiation abilities and financial strength of both parties and the purchaser's ability to utilize the business' assets in a manner particular to them. For example, a purchaser may be willing to acquire a business at a price higher than its fair market value because of potential synergies that could be realized following the acquisition. These synergies may not be available to other purchasers, and as such, they would not be willing to pay the same price. Determining the fair market value of a business, however, provides business owners with a gauge to measure the fairness of any potential purchase offer and a measurement of the current financial condition of their business.

Reference/notes:

1. Business Development Bank. https://www.bdc.ca/en/about/mediaroom/news_releases/pages/more-than-40-of-canadian-entrepreneurs-will-exit-their-business-retire-next-5-years-bdc-study.aspx
2. This is only done if interest expense has not been considered in determining maintainable earnings.
3. EBITDA is a financial metric reflecting a company's earnings before interest payments, depreciation, amortization and taxes.

The role of credit in wealth creation

Many affluent individuals view credit as a wealth management tool, one that can help them take full advantage of business and investment opportunities as they arise. While investments and investment strategy represent core components of an individual's wealth management plan, it's important to remember that one's personal balance sheet includes both assets and liabilities — and to ensure that adequate attention is also placed on the liability side of the personal balance sheet.

Effective integration of credit into the wealth management plan is essential and can support many objectives. For individuals, the role of credit is an evolving one, initially focused on funding an education, a vehicle, personal real estate — and, for many, debt consolidation and repayment. But for high-net-worth investors, over time credit can play a foundational role in both wealth creation and protection, and can help them take full advantage of business and investment opportunities as they arise.

"The effective use of leverage has been fundamental in the success and creation of wealth for many high-net-worth individuals — particularly for business owners," says Ann Bowman, Head, RBC Private Banking Canada.

"We see more and more clients employing leverage strategies. Lending is an important part of our business, and we have expanded our capabilities and resources significantly in support of that over the last several years."

Credit facilities for business owners

A business owner's financial structure is often complex, and includes holding companies and trusts of significant value. Moreover, their needs are particularly complex and require specialized expertise and capability. The wealth planning team that works with the business owner needs to have a clear understanding of the individual's wealth goals and their business interests, as they represent meaningful assets and sources of cash flow.

"I find it's the entrepreneurial spirit and drive behind my clients that have them continuing to uncover ways to build assets and create wealth," says Marian Major, Director, Credit Structures with RBC Private Banking Canada, who works with executives and business owners in Calgary.

"The effective use of leverage has been fundamental in the success and creation of wealth for many high-net-worth individuals — particularly for business owners."

"Over time credit can play a foundational role in both wealth creation and protection, and can help you take full advantage of business and investment opportunities as they arise."

> "Start with your overall wealth goals — and ensure the leverage you employ fits and supports those goals and strategies and is within your risk tolerance."

"These clients think differently, out of the box, and seek partners who understand that way of thinking and can assist in achieving their goals."

"It is essential that we start in the role of partner," adds Major, "and that we explore the client's goals and strategies and dig below the surface to ensure our understanding is complete."

For business owners, the growth of their business is a key component of their wealth, but over time they can accumulate substantial personal wealth — often in the form of personal real estate and investment portfolios. They look for opportunities to add to their asset portfolio, mainly through diversification of investments, and may look for ways of leveraging their accumulated personal wealth.

Major advises that leveraging this personal wealth often makes sense for the entrepreneur. "It can effectively unlock value and create liquidity based on existing holdings — and often the financing is very efficient, cost-effective and flexible in structure compared to more traditional sources," she says.

"In Private Banking, we offer the most flexible solutions; we look towards utilization of all assets in an advantageous manner to create lending facilities with the most fluidity. One of the ways we differentiate ourselves is by pooling collateral such as real estate, portfolios and cash surrender value on life insurance, and that can include multiple entities in the structure."

A full continuum of credit solutions

For the largest facilities, solutions may include lending options such as Banker's Acceptances, LIBOR (London Interbank Offered Rate) facilities, foreign exchange and interest rate swap facilities.

Robert Doyle, Head of Credit Structures for RBC Private Banking Canada, explains that in working with high-net-worth clients, he and his credit team have identified core credit strategies that are typically employed by high-net-worth individuals and their families:

- Managing cash flow and liquidity
- Acquiring real estate
- Diversifying assets/cash flow
- Taking advantage of investment opportunities
- Expanding a business
- Managing taxes
- Managing risk – enhancing risk/return profile
- Reducing borrowing costs through consolidation

"We use these strategies to provide focused advice and develop customized solutions based on their specific circumstances and needs," explains Doyle. "The strategies range from liquidity management to asset diversification and estate planning, particularly as they relate to the business owner: leveraging personal wealth for investment, risk management and tax planning."

Tax is an important consideration. For many business owners, the purpose of leverage is for the earning of investment income and therefore it may be tax-deductible. As well, the use of liquidity lines as an alternative to the sale of assets may be advantageous from a tax planning perspective.

Credit should be considered in the context of overall risk management. Consider what level of exposure to floating rate debt is appropriate — if dealing with assets across multiple jurisdictions, borrowing facilities should potentially include a mix of Canadian and U.S. options. And consider, with your advisors, potential future credit and leverage requirements when establishing personal holdings and trust structures.

Note: Using borrowed money to finance the purchase of securities involves a greater risk than using cash resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by its terms remains the same even if the value of the securities purchased declines.

Putting the credit continuum to work for you

Consider the following: start with your overall wealth goals — and ensure the leverage you employ fits and supports those goals and strategies and is within your risk tolerance.

Ensure it complements and allows for achievement of your other wealth management and personal goals. For example, ensure the cash flow allocated to servicing loans will still allow you to meet your other goals, such as investment and saving for a child's education.

Ensure that the amount of credit employed is conservative in that it supports a long-term investment horizon and can withstand volatility in asset prices and associated cash flow. "Your credit plan should work for you, not against you — and not keep you up at night," says Doyle. "Ideally the proceeds of credit are used for investing and building wealth, as opposed to personal consumption."

For many, particularly high-net-worth individuals, their ability to leverage represents an important advantage and, if used wisely, can work to their advantage in building and growing wealth. For some, today's low interest rates may present a strong borrowing opportunity.

A team approach to the credit continuum

To employ these strategies, it's essential to work with a team that looks at credit in the broader context of wealth management. Every high-net-worth individual's situation is a bit different. Your financial position is, of course, important — but so is your investment strategy, investment horizon, what you hope to achieve through leverage and your risk tolerance.

A proactive, well-thought-out credit strategy can be an integral part of your wealth plan, and adaptable credit facilities can be available and ready to use whenever they are needed.

Note: While this article discusses a range of potential options and strategies, it is critical to consult with qualified advisors and tax and legal professionals to ensure your individual circumstances are properly considered and addressed and that options are best suited to your needs and goals.

Equipment leasing – understanding its value to your business

Making the most of equipment leases as part of business owner planning.

Many business owners would likely agree that when it comes to investing in new equipment, there are countless hours that go into researching and shopping for the most suitable items, as well as considering whether the timing is right to make this type of investment. In general, acquiring new equipment — and this applies to a full range of industries, from manufacturing and construction all the way to medical and knowledge-based industries — can often be an effective way to boost productivity and increase capacity. At the same time, however, the financing aspect can present one of the biggest challenges for many business owners.

"Investing in new business equipment sends a very positive message to your customers — it shows you are willing to invest in improvements to better meet their needs, and it also demonstrates you have confidence in the long-term future of your business," explains Bruce Pennington, Vice President, Equipment Finance, RBC Royal Bank. "But in addition to the equipment decision itself, it's crucial for business owners to give just as much thought to the best option for how they're going to pay for it." This is where it becomes very important to understand how equipment leasing works and the benefits it may offer as an efficient and effective financing alternative that helps to preserve cash flow.

Dispelling common misconceptions

When hearing the word "lease," many may tend to think of it more in the sense of leasing a car, where the lessee has to return the vehicle at the end of the lease, but that type of arrangement can be much different than an equipment lease. As David Magier, Managing Director, Equipment Finance and Leasing – Capital Markets and National Clients, RBC Royal Bank, explains, "For business owners, it's important to recognize that leasing in the commercial space is much different than leasing a car; in a business environment, leasing can provide better cash flow and preservation of capital for more strategic business initiatives. It should be a key consideration in overall business planning."

With most equipment leases, the company leasing the equipment (the lessee) typically has the same rights and obligations as an owner of the equipment would. They possess the equipment, maintain it and insure it. Additionally, the majority of lease financing structures are set up so that when the contracted payments are finished, the client owns the equipment. Many business owners misunderstand that if they lease the equipment, they will have to return it or pay an inflated value to purchase it at the end of the lease. This does not have to be the case if your lease is structured properly for equipment you know you wish to keep long term.

Among some business owners, there's also uncertainty or misunderstanding about which asset classes can and should be considered for leasing. "Some business owners think leasing is available for certain types of equipment only, but it can actually apply to many different types of assets, including point of sale, IT systems, leasehold improvements, and even office furniture and fixtures in certain instances," notes Pennington.

Cash flow management and other benefits

In equipping a business, one of the greatest benefits that leasing offers is the ability to help free up critical cash flow, as it enables business owners to access the equipment they need now, without tying up capital. When business owners opt to pay for equipment outright, doing so may restrict cash flow that could be better deployed to finance sales or to distribute to shareholders. Leasing, on the other hand, provides an opportunity to direct that working capital to where it may be more useful at the time. Additionally, by freeing up cash, leasing can also help business owners take advantage of growth opportunities.

With these benefits in mind, both Pennington and Magier emphasize that it's worthwhile for business owners to consider leasing as part of their overall cash flow management strategy.

With flexible lease terms, purchase options, currency choices and payment schedules, leasing also adds an extra layer of flexibility, which can aid in meeting cash flow requirements. "In some cases, there may also be the ability to match your lease payments to your cash inflows," explains Pennington. "In addition, most lease payments can be expensed and leasing may help to mitigate certain tax consequences. Also, some business owners may be unaware that there is the ability to fund 100 percent of the purchase price, including the taxes."

Understanding your options

Within the realm of equipment leasing, there is a range of options available. For example, business owners can choose fixed or variable interest rates, and the lease terms can be structured to fit your cash flow needs, both now and in the future. There are also lease lines of credit that may make managing multiple leases with varying terms easier for business owners.

Specifically in terms of structure, a variety of lease types and options exist. For example, a lease can be structured where the asset is leased for a set term and you buy it for a predetermined amount at the end. Or, you can lease an asset for a set term and then have the option at the end to return it to the lease finance provider (lessor). "The main thing to understand is that leases can offer flexibility to meet unique business owner needs and can be structured in many ways, depending on your goals and circumstances," notes Magier. "We work with some of the largest companies in North America that leverage equipment lease structures as part of their capital procurement and management strategy. Many of them use leasing solutions even when they maintain

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Taking the right steps when considering a lease

In determining whether leasing is an ideal option for your business, there are a number of important considerations to take into account, including:

- How long you will use the asset, whether it will quickly become obsolete and whether you prefer to upgrade every few years or own it at the end of the term
- Your cash flow situation and requirements
- Your company's balance sheet presentation
- The current pace of change in business and technology
- The current stage of the business in its life cycle

"Before deciding to lease, it's important to fully understand if, and how, a lease finance structure might benefit your company, so consulting with an expert should always be a first step," notes Magier. "All financial circumstances need to be considered, and this is where a qualified equipment finance specialist plays a crucial role in working with the business owner, their management team and advisors so that everyone understands the options that are available."

> "At the end of the day," Pennington emphasizes, "it's about doing what's best for the sustainability of the business. When it makes the most sense and when done properly, leasing can be a smart way to invest in the long-term competitiveness of your business."

Upcoming legislative changes

Beginning in January 2019, there will be new lease accounting standards for public entities that have to report under the International Financial Reporting Standards (IFRS) and Financial Accounting Standards Board (FASB/US GAAP). In 2020, these new requirements will also apply to private businesses that report under these two standards. For Canadian businesses reporting under Accounting Standards for Private Enterprise, there are no planned changes at this stage.

substantial cash balances. Having finance solutions that fit into their equipment procurement process with consistent documents, terms and pricing are additional benefits for them. Leases can allow business owners to structure against the useful life of the equipment in comparison to a traditional bank or credit union term loan. If you're buying equipment that has a market established 10-year useful life, then it can be structured that way to support your business' cash flow."

And Pennington reinforces the value of this type of flexibility in today's business environment: "In business and in the marketplace, the introduction of risk continues to accelerate and the pace of change has accelerated. With leasing, which is probably the most flexible financing option available, options exist to give business owners the opportunity to refresh routinely, and to manage change and risks as they evolve."

Leasing and business owner planning

With statistics indicating that a large percentage of Canadian business owners will be exiting their businesses over the next decade, many may be considering either selling their business or transferring it to the next generation — as well as how to free up enough funds to carry them through retirement. In both of these scenarios, leasing may be a valuable option to examine and utilize.

> "The main thing to understand is that leases can offer flexibility to meet unique business owner needs and can be structured in many ways, depending on your goals and circumstances."

For business owners planning to sell their business, balance sheet presentation is often reviewed in an effort to make the business look more attractive to potential buyers. As part of planning in this regard, there may be an opportunity to use leasing as part of the business' capital structure for balance sheet purposes. One way this can be accomplished is through a sale-leaseback of assets. With a sale-leaseback, business owners can sell equipment they own outright (to a lessor) with a commitment from the lessor to immediately lease their equipment back to them. This type of arrangement unlocks the equity in those assets, freeing it up to be redeployed within the company and for purposes that may be strategically important.

This same approach may be useful in a situation where successors or the next generation will be coming in to take over the business. With a sale-leaseback arrangement, business owners get the freed-up equity, and can then decide how to take it out of the business to fund their retirement. This type of approach places some accountability on the next generation, as they must manage the business effectively to repay the lease.

Note: If you are a current business owner, to ensure your specific needs and circumstances are properly addressed and accounted for, it is crucial to engage qualified accounting and tax advisors in concert with your equipment finance specialists when considering potential lease structures for your business.

Your business EXIT strategy

What options are available?
What are some of the common issues?
How can you get the business ready for sale?

While some business owners have given considerable thought to the transition of their business and have a fully developed succession plan in place, many others have not given it much consideration. Business owners who have developed a well-thought-out transition plan have positioned themselves and their families for a better outcome whenever that event occurs.

Exit options

There are a limited number of options available to any private owner wanting to exit his or her business and each situation is unique, so those options can be limited even further by the specific circumstances of the situation.

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

"In my experience, no two shareholder situations are the same and understanding the true goals of the parties involved can help determine the best option for the shareholder," says Paul Morgan, Managing Director, RBC Mid-Market Mergers and Acquisitions. "If keeping the business in the extended family is the most important goal, the business will in all likelihood be transferred to a related party; however, if maximizing proceeds on sale is most important, shareholders will typically look to sell to a third party."

Selling/transferring to a family member

Keeping a business in the family and transferring it from one generation to the next can be very appealing to a business owner and his or her family. This option is usually selected by an owner who wants to see the business continue in a similar fashion. If done well — and seamlessly — one of the benefits of this approach is a reduced risk that there will be negative consequences from customers, suppliers or employees.

However, exiting a business can be very complicated and difficult at the best of times, and adding family dynamics to the situation can create considerable strain and stress that may have long-term adverse consequences on the family.

Choosing the right successor will generally have a significant impact on the future success of the business and, potentially, the family's overall wealth. It is not always necessary to consider all family members when selecting a new leader. If the business is large and complex, it will need an experienced person to effectively manage the business to its potential. A person with that skill set may not exist in the family and, unfortunately, it is sometimes hard for a family to draw that conclusion on its own.

"I have found that outside assistance is often warranted in these situations," says Morgan. "Business facilitators can be engaged to evaluate the capabilities of the family members and ultimately make recommendations to the family as to successor suitability. It helps to take some of the emotion out of the decision for a family, but it is never easy."

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In general, transfers to the next generation are fairly common and can be a viable option for a business owner if there is a capable and qualified successor within the family ranks.

Management buyout

A management buyout (MBO) is another attractive option for an owner wanting to exit his or her business. Selling to an MBO team can have many positive aspects.

The MBO team and the seller typically are very familiar with one another and recognize the win-win nature of the transaction. This may lead to fewer “hard positions” being taken and ultimately to an increased likelihood of a timely closing of the purchase and sale.

A top management team will also have fundamental insights into the business that will make the due diligence process (including accounting, business and legal) almost non-existent as compared to the same process with a third-party buyer. In addition, if the management team has a strong track record of operating the business, debt financing a portion of the purchase price should also be comparatively easier. The transition risk is also minimized, as the MBO team is already known to customers, suppliers and employees, and may limit the disruption to the business when ownership transfers.

In all leveraged buyouts, determining the amount and source of the equity component of the purchase price is vital and MBOs are no different. Internal buyers (whether a family member or a management team) will typically have access to limited amounts of cash or equity to use. Therefore, in most small- to mid-sized companies that are considering an MBO, the vendor typically has to co-operate to a great extent with the management team, offering a favourable purchase price and providing a vendor note on favourable terms, to enable the deal to close in a timely manner.

In the case of mid- to large-sized companies, management teams will typically partner with a financial partner that can provide a significant portion of the equity component of the purchase price. While this can be appealing to a management team, it does have its drawbacks. If they can contribute only a small portion of the total equity required, they will receive only a small portion of the ownership. Some management teams may or may not be willing to risk personal assets, have limited control and report into a new organization for a small ownership position. Everyone’s goals and risk tolerances are different. Understanding the nuances of MBOs will enable a business owner to determine if this is a viable option in his or her situation.

Partner/shareholder buyout

Selling to an existing business partner provides the benefit of working with a known party and may lead to quick and uneventful closing as compared to dealing with a third party. Unfortunately, any discord between partners can create a long, drawn-out process. Common issues may typically arise around valuation and payment terms. A well-devised and up-to-date shareholders' agreement will lay out the rules and basic steps to follow when transitioning any ownership interest and can help smooth out the process.

Depending on the circumstances, financing these transactions may be relatively straightforward. There are a number of factors that impact a financial institution's willingness to finance the buyer (assuming a reasonable, profitable business). These include: the buying partner's track record of operating the business; a reasonable valuation; the existence of non-compete/non-solicitation clauses; and the absence of any foreseeable adverse affects on the business or its relationships from the loss of the partner exiting. In the right situation, by leveraging the cash flow of the business, the buying partner can generate a significant return on his or her investment.

Selling to external parties

A business owner can also approach third-party buyers (or engage an intermediary to do so on his or her behalf), such as strategic buyers or private equity groups (PEGs), to determine their interest in purchasing the business.

"If the business owner is attempting to get the highest and best offer for his or her business, engaging a professional to run the divestiture process will usually result in the best deal," suggests Morgan.

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 risks, and they have the potential to extract various synergies. Due to their competitive position in the marketplace, strategic buyers are usually 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.

Financial buyers, or PEGs, are looking for businesses with quality management teams, a strong earnings history, good margins/projected financial results, a sustainable competitive position in the industry and attractive long-term prospects. 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. Generally, PEGs have a very professional approach to the acquisition and can be a good option if the business meets many of the characteristics outlined earlier.

In general, selling to third-party buyers is considered to be a good option for an owner who wants to exit his or her business and maximize deal terms.

Your exit options

- **Keeping it in the family.** **The upside:** Continuity, family legacy. **The downside:** Family squabbles, potential lack of qualified successors.

- **Management buyout (MBO).** **The upside:** Easier transition, experienced new leadership. **The downside:** Management may not have cash, forcing you to accept a lower sale value.

- **Partner/shareholder buyout.** **The upside:** Continuity, often a quick closing. **The downside:** Arguments over valuation.

- **Selling to external buyer.** **The upside:** Quick, clean getaway with maximum value. **The downside:** Disclosing confidential information to a competitor who may decide not to buy.

> When it comes to exiting a business, the statement "all situations are different" is very applicable. While there are a number of options, understanding your goals and objectives can often guide your exit strategy. If it is important to see the business continue into the future in a similar fashion, the internal buyer is a likely choice. However, if the objective is to maximize deal terms, the preferred choice may be a sale to a third party.

Getting your business ready for sale

There are a number of items business owners should consider when preparing their organization for a sale. The most common factors to review and analyze are: shareholder/tax planning opportunities, the management team, the company's management information systems, the customer base, the timing of the sale and cash flow.

Shareholder wealth and tax planning

A proactive approach to integrated family wealth and tax planning can produce a number of benefits for the shareholder and the family. Working with experienced, qualified professionals to set up a sound wealth and tax plan will help to eliminate risk in the transition process and ultimately lead to more after-tax proceeds following the sale. Additionally, engaging your qualified advisors early will give you the ability to think about your options thoroughly.

Management team

Existing business owners should evaluate the depth and breadth of their 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, and the potential for problems will increase 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 transitioning. 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, which often translates into higher value. In addition, the due diligence process can be onerous, and having an ability to produce good information is a benefit to both the buyer and the seller.

Customer base

"Customer concentration is one of the most common problems in businesses that we see," says Morgan. "If no action is taken to lessen the importance of that one major customer, this may limit the value and have an unfavourable impact on how the sale proceeds are paid."

A potential buyer is ideally looking for a growing and diversified customer base. A business that is heavily reliant on one customer presents a substantial risk due to the potential that the business' value will decline if that customer leaves. To the extent possible, expanding the number and quality of your customers will have a positive impact on the value of the business.

Timing of the sale

Running a good business with a good management team provides the shareholder with a greater ability to determine the timing of the sale. The best time is generally when the business is performing well, the economy is doing well and the potential for the industry is positive. Sometimes things do not work out as planned and poor operating results occur. Timing of the sale in this situation is tricky and usually delayed until a year of good results post-turnaround have occurred or some other strong evidence exists that the business is now performing well.

Cash flow

"Companies that attract a higher multiple when sold generally have a high-quality cash flow (consistent, recurring, high margin and growing) and are in an industry that has favourable growth prospects," says Morgan.

Cash flow tends to determine value and the better the quality of the cash flow and its growth potential, the greater the value. One of the best ways to improve it 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. Anything that creates a sense of risk or uncertainty in the buyer's mind will have an adverse effect on value so a careful review and improvement of the factors that impact value will have a positive overall effect on the transitioning of the business.

Note: Given the complexities involved in business succession and that each business owner's circumstances and goals are different, it is crucial to consult with qualified advisors and tax and legal professionals to ensure your situation is properly addressed and that planning is carried out to best suit your needs and goals.

Employee loyalty

Attracting and retaining top talent.

As a business owner, you know how important it is to recruit, reward and retain your top talent. It can help ensure business continuity, protect the knowledge you have accumulated within your organization and may help you make effective succession planning decisions when the time comes. The loss of a key employee can be very disruptive and costly to an organization, so give some thought as to how you can motivate key employees and keep them focused on the company's priorities.

Employer-sponsored savings plans

Employees are increasingly conscious of the necessity to provide for their retirement. Employer-sponsored savings plans are one of the most important aspects of retirement planning and can help you ensure that your employees enjoy a financially secure retirement. Before setting up a retirement plan, discuss the options with your professional legal, tax and/or financial advisors. Here are some of the more common types of retirement plans offered by employers.

Group Registered Retirement Savings Plans (Group RRSPs)

Group RRSPs are a cost-effective way of encouraging your employees to save for retirement throughout their careers. They could be an option even for a small business owner. These plans operate like regular Registered Retirement Savings Plans (RRSPs), possibly with additional restrictions, and can be more cost-effective and easier to administer than pension plans.

Registered Pension Plans (RPPs)

RPPs are employer-sponsored pension plans. In general, employer and employee contributions are tax-deductible and the income earned within the plan grows tax-deferred. Funds accumulating within the plan for individual members are generally locked in by provincial or federal legislation.

There are two kinds of RPPs: Defined Contribution (DC) and Defined Benefit (DB) pension plans.

Employees with DC pension plans will have a retirement benefit based on the value of the plan when the employee retires.

In contrast, DB plans guarantee a specific benefit to the employee at retirement, calculated using a formula based on earnings and years of service. DB plans generally specify an age, usually 65, at which employees are expected to start receiving retirement income.

As an employer, you face a potentially greater obligation with a DB plan than a DC plan because you are making the investment decisions and guaranteeing a fixed benefit to the employee at retirement.

If there are insufficient funds in the plan, you may also be required to top up the plan by making a greater current cash flow commitment to the DB plan than expected. However, if there is a surplus in the plan, you may have reduced payments.

Group RRSPs are a cost-effective way of encouraging your employees to save for retirement throughout their careers.

Learn from experience

While financial compensation often attracts your key employees, non-financial benefits often help you retain them. Sufficient tools and time to do the job are essential to employee satisfaction while training and career development help to keep them motivated. Aim to foster a social environment and a sense of team, and demonstrate your commitment by ensuring that work/life balance can be achieved.

If you lose a key employee, hold an exit interview so you understand the reasons for his or her departure. The individual's dissatisfaction may indicate problems among other key employees and may save you from another costly loss.

Enhanced retirement benefits

The following options may help you enhance the retirement savings plans of your key employees:

Supplemental Executive Retirement Plans (SERPs)

Limits on registered plan contributions and benefits can leave your higher-income employees with retirement benefits that are inadequate to maintain their standard of living. A SERP may help to bridge the gap between the maximum pension available under the company's RPP and what a higher-income employee would otherwise need in retirement. It can also be a way to help you retain your valuable employees and encourage their long-term loyalty.

One of the most common forms of a SERP is the Retirement Compensation Agreement (RCA). An RCA is a non-registered pension arrangement that can help you provide supplemental pension benefits for key employees and can be utilized whether your company has an RPP or not.

RCAs have no contribution limits (provided contributions are "reasonable") and no investment restrictions. Employees may also be able to benefit from certain investment strategies involving life insurance. This can provide supplemental tax-exempt investment income and may yield better results than other investments.

Individual Pension Plans (IPPs)

An IPP is a registered DB plan sponsored by an employer for one individual and potentially that individual's spouse if the spouse also works for the company. It is an alternative to having an RRSP. The company makes a contribution to the IPP, which is a deductible expense, as opposed to the individual making an RRSP contribution, personally. Usually, after age 40, the contributions that can be made to an IPP are higher than those that can be made by an individual to his or her RRSP. If the investment earnings within the IPP are lower than required by legislation, the company will likely have to make additional contributions. IPP assets may offer creditor protection and typically suit business owners, incorporated professionals or key employees.

Note: This information provides a non-exhaustive overview of potential options to consider, which may not be suitable for every business or business owner. Given that each business is unique in structure and circumstances, it is crucial to consult with your qualified advisor and tax and legal professionals to ensure your needs and goals are properly addressed.

Is incorporating your professional practice right for you?

Every Canadian province and territory has enacted legislation that allows professionals to incorporate. From this stems the ability to benefit from certain tax advantages of operating a practice through a corporation. If you are thinking of incorporating your practice, you should consider both the possible advantages and drawbacks of incorporation.

What is a professional corporation?

A professional corporation is a corporation owned and operated by one or more members of the same profession, such as physicians, lawyers, accountants or dentists. The services provided by the corporation are generally restricted to the practice of the profession. Professional corporations are allowed in every province and territory across Canada, although in each jurisdiction, it is the professional regulatory body that usually determines whether its members may incorporate. For example, the regulatory body for physicians, in all provinces and territories, allows physicians to incorporate.

A professional corporation is restricted by the rules set out by the governing regulatory body. For instance, the regulatory bodies provide rules on who can be the voting and non-voting shareholders of the professional corporation. In many, but not all, provinces and territories, only members of the same profession can be voting shareholders of a professional corporation. The rules may also specify whether certain entities can be shareholders, for example, whether a holding company or a family trust can hold the non-voting shares. The officers and directors of a professional corporation must generally be shareholders of the corporation as well.

Potential advantages of incorporation

There are several potential advantages to incorporating your professional practice that would not be available if you operated as a sole proprietor.

Tax deferral

Perhaps the most significant advantage of operating your practice within a corporation is the ability to defer taxes. Professional income earned within a corporation is taxed at two levels — once at the corporate level and then again at the personal level when the income is distributed. By incorporating, you have the flexibility to defer personal taxation on the after-tax professional income retained in the corporation until the time you withdraw it. Generally, the longer you can leave the funds in your corporation, the greater the deferral advantage will be.

This tax deferral benefit is potentially further augmented because income earned from operating your practice within a corporation may be taxed at lower corporate tax rates than professional income earned while operating as a sole proprietor, where the income is taxed at your individual marginal tax rate. In many of the provinces and territories, the highest marginal tax rate for individuals is higher than 50 percent for 2018. If the professional income earned by your corporation is considered active business income, it is subject to a lower corporate tax rate, which ranges between approximately 26.5 percent and 31 percent for 2018, depending on the corporation's province or territory of residence. Further, if your corporation is a Canadian-controlled private corporation (CCPC) throughout the tax year, your corporation may benefit from the federal small business deduction, which lowers the tax rate even further on the first $500,000 of active business income (known as the "business limit"). The amount of the business limit and the small business deduction rate vary by province or territory. Additional criteria must be met in order to qualify for the Quebec small business deduction. Corporations will only qualify for the Quebec small business deduction if they operate in the primary or manufacturing sectors or where the corporation's employees worked at least 5,500 hours during the tax year. For 2018, the combined federal and provincial tax on the income subject to the small business rate ranges between approximately 12 percent and 22 percent.

As a result of these lower corporate tax rates for active business income, you may have more after-tax professional income within the corporation to invest. However, in an attempt to limit this tax deferral benefit for corporations, the federal government introduced rules, in addition to ones that already exist, to restrict access to the small business deduction for CCPCs that earn significant income from passive investments (such as interest, dividends and capital gains).

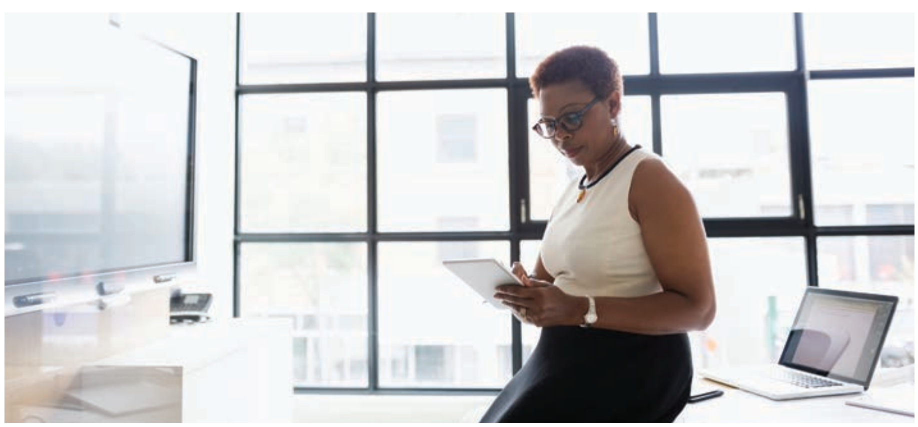
For tax years that begin after 2018, a CCPC will have its federal business limit reduced where the CCPC and its associated corporations[1] earn between $50,000 and $150,000 of passive investment income in a year. The CCPC's business limit will be eliminated where passive investment income exceeds $150,000. As such, if you incorporate your practice, you may want to ensure that the level of passive investment income earned in your corporation, or associated corporations, does not impact your small business limit.

Income splitting opportunities

Incorporating your practice may allow you to take advantage of income splitting opportunities. By having your lower-income adult family members as shareholders, it is possible for your incorporated business to pay them dividends to take advantage of their lower marginal tax rates. However, this strategy may be less applicable to professional corporations situated in provinces or territories where share ownership is restricted to members of a particular profession.

When paying dividends to family members, it is important to keep in mind that there are "tax on split income" (TOSI) rules that limit splitting certain types of income

Determining how to structure your practice is an important decision that may have a significant impact on your practice going forward.



with family members. These TOSI rules apply to many types of income received from a private corporation, including interest and dividends, as well as certain capital gains, but they do not apply to salaries or bonuses. Where TOSI applies, the income is subject to tax at the highest marginal rate, regardless of the individual's actual marginal tax rate. In addition, the individual who receives split income loses the ability to claim certain personal tax credits on the split income, such as the basic personal tax credit.

There are some exclusions to TOSI; however, the exclusions are more limited for professional corporations. The exclusions differ depending on the age of the family member receiving the income (i.e. minors under age 18, adults age 18 to 24 and adults age 25 and over) and mainly rely on whether the family member is significantly involved in the business. There is also a specific exclusion available for the spouse of a professional who is 65 years of age or older.

It is worth noting that you can also pay reasonable salaries to your family members for the services they provide, without having to incorporate or add them as shareholders of your corporation. In doing so, you can take advantage of your family members' lower marginal tax rates while generating Registered Retirement Savings Plan (RRSP) contribution room for them at the same time. You or your corporation can claim a deduction for the reasonable salaries paid.

The Lifetime Capital Gains Exemption (LCGE)

You may enjoy a significant tax break on the capital gains you realize on the disposition of certain private company shares. Each individual resident in Canada can claim an LCGE to shelter capital gains on the disposition of qualified small business corporation (QSBC) shares. The LCGE is $848,252 for 2018 and it is indexed annually. Therefore, incorporating your practice may enable you to sell your practice and shelter the growth from tax, up to the LCGE limit. Please note that the ability to sell the shares of your professional practice might be limited due to the requirement that voting shares generally have to be owned by individuals of the same profession.

You and your family may also be able to multiply the LCGE available on the disposition of QSBC shares if you and your family members own shares of your professional corporation, directly or indirectly. For example, instead of being able to claim only one LCGE of $848,252, a family of four can shelter up to approximately $3.39 million of capital gains, resulting in significant tax savings. Please note that if you multiply the LCGE with your family members, they become entitled to some of the proceeds of sale. It is important that this is your intention when contemplating such planning.

Also, you should consider speaking to a qualified tax advisor if you are a sole proprietor and planning to sell your practice, since you may be able to claim the LCGE by transferring all or substantially all of your professional assets into a corporation and immediately selling the shares of the newly formed professional corporation.

Flexibility in remuneration

By incorporating your practice, you gain access to a combination of different forms of remuneration, including salary, dividends and bonuses. The ability to choose the type and amount of remuneration may allow you to maximize the tax deferral while still taking advantage of benefits such as creating RRSP contribution room and participating in the Canada Pension Plan or the Quebec Pension Plan.

Flexibility in employee benefits

By incorporating your practice, you gain access to certain types of retirement savings plans, such as an Individual Pension Plan (IPP)

By incorporating your practice, you gain access to certain types of retirement savings plans, such as an Individual Pension Plan (IPP) and a Retirement Compensation Arrangement (RCA) that would otherwise not be available if you were a sole proprietor.

and a Retirement Compensation Arrangement (RCA) that would otherwise not be available if you were a sole proprietor.

Period of existence

If you operated your practice as a sole proprietor, your business would cease to exist upon your death. On the other hand, if you incorporated, your corporation would continue to exist even if every shareholder and director were to pass away. When the professional dies or no longer practices (assuming there are no other professional shareholders), the corporation would lose its status as a professional corporation. This does not mean that the corporation would have to be wound up; it may continue to exist as a regular corporation.

Limited liability

Incorporation limits the liability of a corporation's shareholders. The shareholders of a corporation are generally not responsible for the corporation's liabilities unless they have provided a personal guarantee. That said, a professional corporation does not usually protect you from personal liability for professional negligence. In addition, if a shareholder is also a director, that person could be liable for certain professional corporate liabilities (which may include unpaid wages and payroll taxes) in his or her capacity as a director.

Potential disadvantages of incorporation

While incorporating your practice may provide certain advantages, you may need to weigh these benefits against the potential disadvantages of incorporating, such as the initial and ongoing accounting and legal costs of incorporation.

Increased complexity and cost

Operating your practice through a corporation may require you to adhere to a number of corporate formalities. For example, regardless of whether you are the sole owner or one of many owners of your incorporated practice, the directors of the corporation need to pass a resolution to declare and pay dividends. A corporation is also subject to greater regulation and compliance than a sole proprietorship. For instance, your corporation will have to hold annual shareholder meetings and maintain corporate records. And, if there are any changes to the board of directors, your corporation will have to file notices with the government.

The administrative, legal and accounting costs associated with establishing and maintaining a corporation are also usually higher than those of a sole proprietorship, which include various corporate tax and other filings.

Restricted use of business losses

Generally, in the first few years of operation, a practice can generate losses due to high start-up costs and/or building a client base. As a sole proprietor, you may use any professional losses to offset your personal income from other sources. However, once you have incorporated, any losses realized in the corporation must be applied against the corporation's income and cannot be used to offset your personal income. Whether you incur these losses as a sole proprietor or through your corporation, if you cannot use the losses in the year they are incurred, they are not completely lost. Professional losses can generally be carried back three years and forward for 20 years to use against past or future income.

Restricted personal use of corporate funds

All of the professional income you earn as a sole proprietor is taxed in your hands annually. As such, you can use the after-tax profits however you wish. On the other hand, if you incorporate your business, the after-tax profits belong to the professional corporation and you cannot use the corporate funds for personal expenses unless you first withdraw the money from the corporation. Depending on how you withdraw funds from the corporation (e.g. as salary, bonus or dividend), you will face different tax implications on the withdrawal.

> Speak with a qualified tax and legal advisor to ensure that you have taken into account all of your circumstances before deciding whether or not to incorporate.

Taxes at death

If you own shares of your corporation, you may be subject to double taxation on death. First, you are taxed on the capital gain arising from the deemed disposition of your shares at death. Then, if the corporation is wound up, shares are redeemed or the corporation makes distributions to its shareholders, a second level of tax is triggered. There are post-mortem planning alternatives that may eliminate this double taxation. For more information on strategies that may mitigate this double tax exposure, talk to a qualified tax advisor.

Weigh the pros and cons

Determining how to structure your practice is an important decision that may have a significant impact on your practice going forward. Weigh the pros and cons associated with incorporating and see how they measure up with your specific objectives.

Note: Given the complex nature of these planning considerations and because every individual situation is unique, it is important to speak with a qualified tax and legal advisor to ensure that you have taken into account all of your circumstances before deciding whether or not to incorporate.

Reference:
[1] The term "associated corporations" is defined in the Income Tax Act. The definition is complex and is beyond the scope of this article.

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