

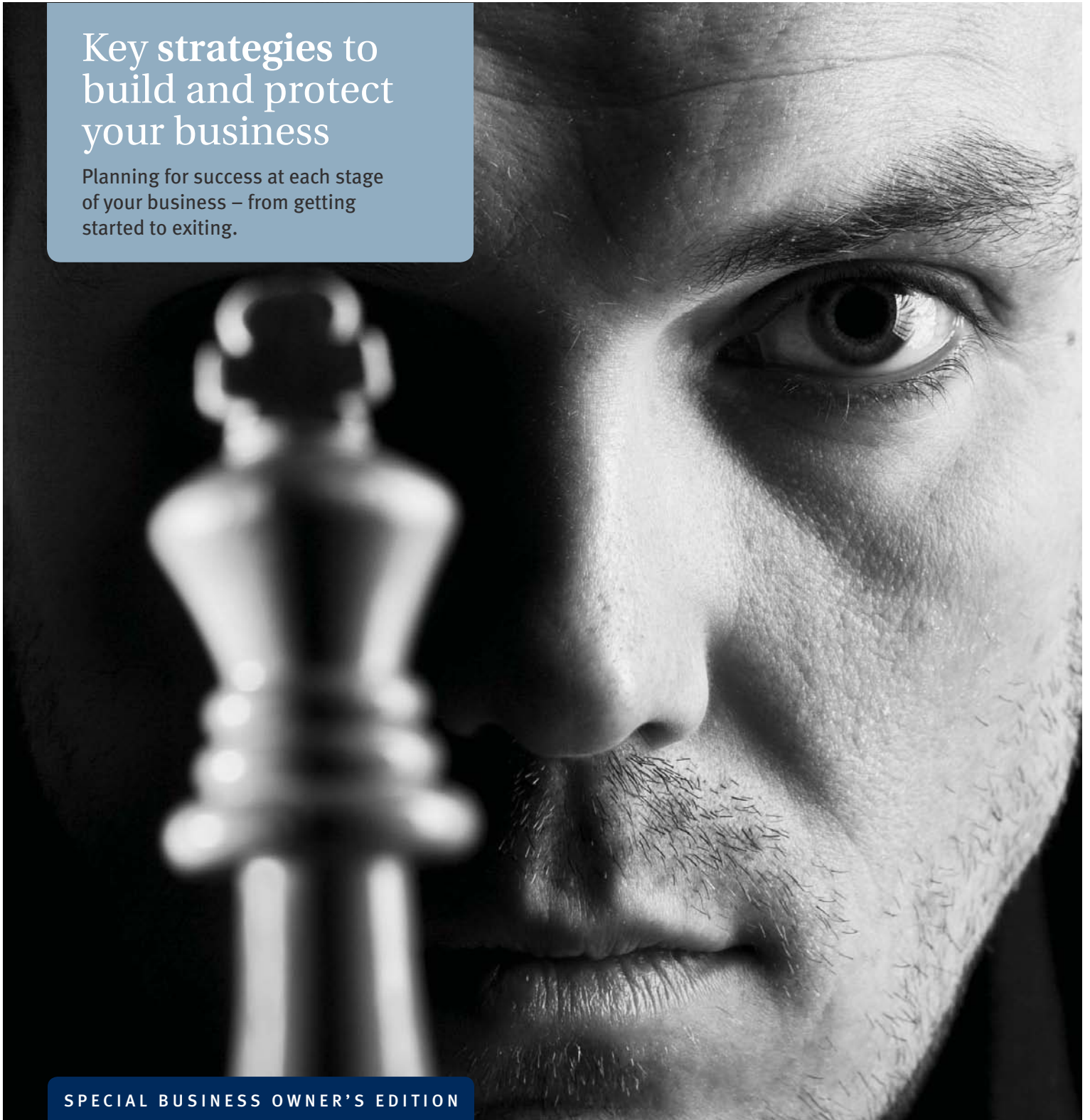
# PERSPECTIVES

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

## Key strategies to build and protect your business

Planning for success at each stage  
of your business – from getting  
started to exiting.

SPECIAL BUSINESS OWNER'S EDITION





## From the desk of David Agnew

**Welcome to the third issue of RBC Wealth Management *Perspectives*. The response to our first two issues was overwhelmingly positive. We heard from many readers who had specific wealth planning questions about the value of their businesses – not surprising, given that more than 50% of high-net-worth Canadians are business owners.**

This issue provides information to help business owners through the life of a business: from establishment, to growth, to transition, to exiting.

Building and protecting a business is no easy task, especially in a rapidly changing economic environment. This issue features two articles on how leverage, whether through the integration of credit or investing in new business equipment, can play a foundational role in growing a successful business. Articles on Power of Attorney and key person insurance examine the potential risks of failing to plan for how the business should operate in their absence.

Advance planning is also fundamental when transitioning out of a business. While an estimated 120,000+ Canadian business

owners plan on selling their businesses in the next 5-10 years, many still do not have a fully developed succession plan in place. Articles on succession planning provide insight for private business owners considering their exit options, and family business owners looking to pass down assets to the next generation.

Finally, before the sale of any business, business owners need to know how much the business is worth, as well as the appropriate tax strategy to follow, as examined in two articles on valuing the business and minimizing taxes.

I encourage you to contact your RBC Wealth Management advisor about the topics featured in this issue and to explore other ways to address your wealth management needs and goals – for your family, your business and yourself.

**David Agnew**

CEO, RBC Wealth Management Canada



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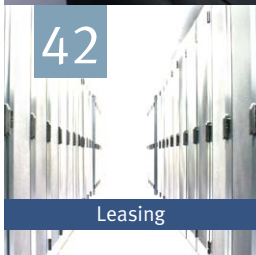
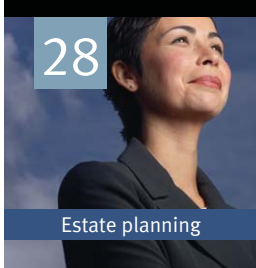
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Water is so much a part of our daily lives that we rarely think about it and often take it for granted.



# Keeping it in the family: managing conflict through planning

An ideal scenario for many family business owners is to pass their assets down from one generation to the next. Unfortunately, statistics<sup>1</sup> reveal that failure rates for family businesses increase with each successive generation. In fact, the Family Firm Institute estimates that only 30% of U.S. family firms survive the shift to the second generation, only 12% are still viable in the third generation and only 3% make it to the fourth generation or beyond.



“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.

The failure rate for intergenerational business transfers can be attributed to several factors, including an inability to manage conflict and preserve harmony among family members. But the success of a family business can rest on the family’s ability to address and resolve conflict when it does arise. Discord between family members can lead to hot-headed decisions and the potential demise of the business.

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

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<sup>1</sup> Family Firm Institute, “Global Data Points”  
<http://www.ffi.org/?page=GlobalDataPoints>

### **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 professional advisors**

Assemble a team of professional 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 the criteria you have in mind for a successor, consider dividing the responsibilities of operating the business between multiple family members and creating clearly defined roles for each person. This way each member has the opportunity to excel

in their 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 could lead to hostility, which will be counterproductive for the success and longevity of the business.

### **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 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 fosters 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 be seen as collaborative and

*Continued on page 5*

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 professional advisors to attend occasionally.



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 make the transition a success. Their input can minimize potential conflict and help maintain stability in the business and in the family.

### **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 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, you can keep your business in the family and have it run harmoniously and successfully.

You have a business plan.  
What's your retirement plan?









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



**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 be less well diversified than 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, consider that many business owners each year are unable to sell their businesses for a variety of reasons, including difficulties finding a suitable buyer and obtaining financing for the successor once they have been identified.

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, Prashant says.

Holding some of your retirement savings outside the business can reduce your risk. If you withdraw profits, this may protect them from future business losses. By paying yourself a salary, instead of taking dividends, you can benefit from personal income tax deferral by contributing to a Registered Retirement Savings Plan (RRSP) or an Individual Pension Plan (IPP).

IPPs have been available for over 10 years but were not as common in practice because of higher administration costs and low pension limits. Now, IPPs are offered at much lower cost and the government has increased the limits for tax-sheltered pensions. The combination of these factors has sparked renewed interest in IPPs.

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. An IPP generally enables you to make higher tax-deductible contributions than the maximum permitted for RRSPs. Although there is no minimum income level, typically those earning T4 salary of more than \$125,000 per year 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 IPP contributions replace your contributions to an RRSP. Similar 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% expected actuarial interest rate (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 trustee 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 that there is less flexibility compared to an RRSP when it comes to withdrawals from the IPP.

To allow for additional pension income flexibility, some of the provinces such as Ontario and Alberta (and also federally legislated plans) offer partial unlocking of locked-in plans at certain minimum ages.

**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. ❖



There are many intricacies to IPPs, so it is imperative to understand all 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 – died 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’s 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 are no longer unexpected or unmanageable.
- There can be significant tax saving 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 Joel. “Key person insurance is a cost-effective way to help ensure the ongoing operation and continued success of your business.”

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

### 1. Key person life insurance

Life insurance is usually the cornerstone of a key person protection strategy. It provides an immediate injection of tax-free capital into the business upon the death of the key person. Life insurance not only provides effective low-cost funding in the event of a key person loss, it can also fund buy-sell agreements and offers considerable flexibility in how an arrangement is structured.

### 2. Key person disability insurance

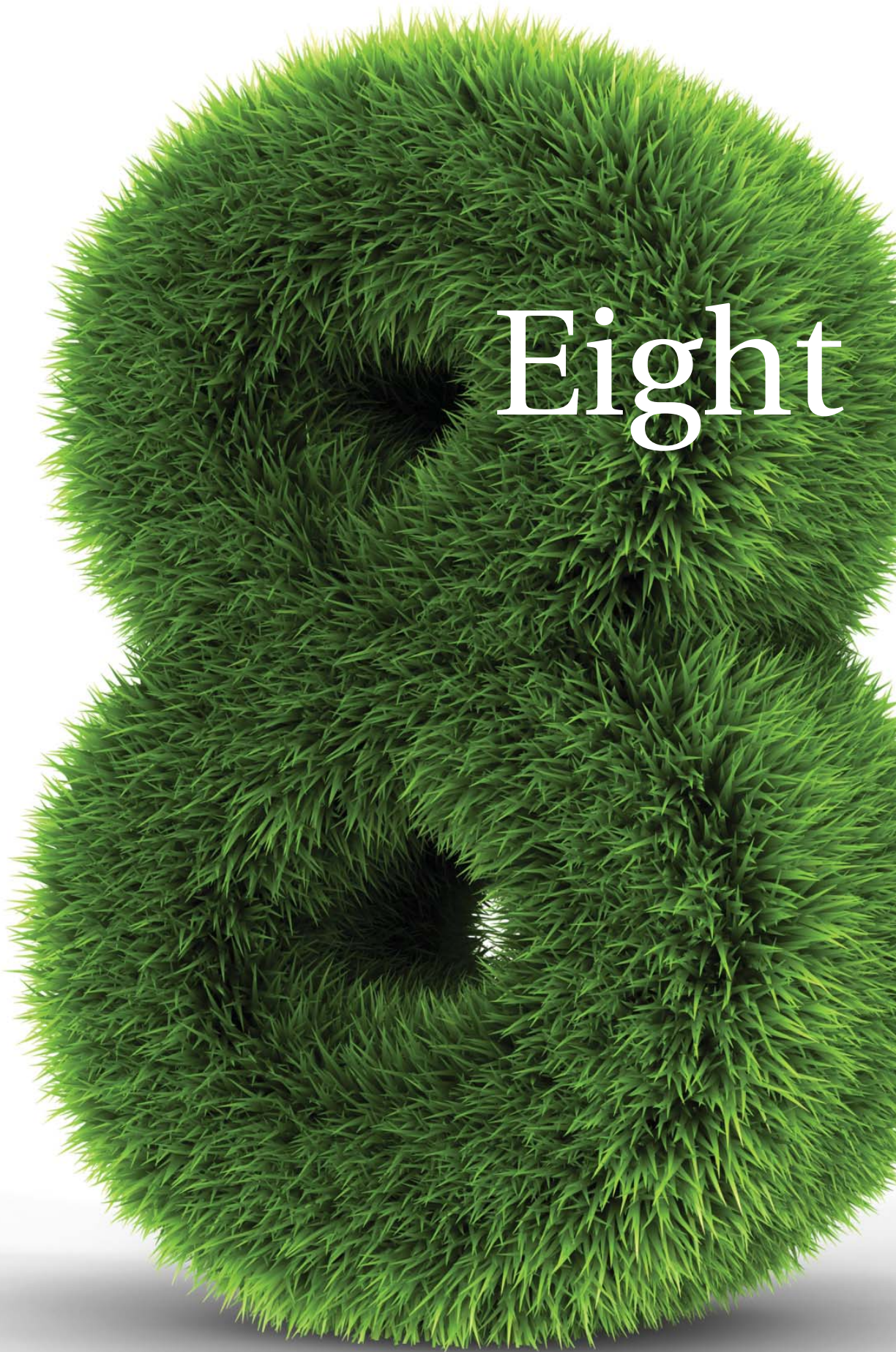
Disability insurance can be used for two purposes. One, the insurance can provide salary continuation to the key person in the event that they become disabled, usually until the earlier of age 65 or recovery from the disability. Two, the owner/manager can purchase insurance that provides continued payment 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 them disabled, but nevertheless affects their productivity or their desire to work to the same extent as before. This coverage will pay a lump sum, or in some cases, a stream of income to the business 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 ensure your business’s continued success in the long term. ❖





## SHAREHOLDERS' AGREEMENTS

# essential questions

In principle, everyone understands the need for a shareholders' agreement when several parties are working together toward a common goal – whether as a partnership, incorporated company or any other type of formal partnership. However, it's not uncommon for business partners to get wrapped up in running their business and either neglect to finalize their shareholders' agreement or forget to update it.

A shareholders' agreement should be prepared exclusively with the company, legal entities, shareholders and their families in mind. Although this document can never cover all the potential risks and events, some basic elements should be considered any time a shareholders' agreement is being drafted or revised. The list below, although not exhaustive, outlines certain questions that you should ask yourself when revising your shareholders' agreement.



**1. 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.

Unfortunately, even the best shareholders' agreement cannot prevent a potential disaster. A contingency plan addresses the company's operations in the face of such an issue. 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.

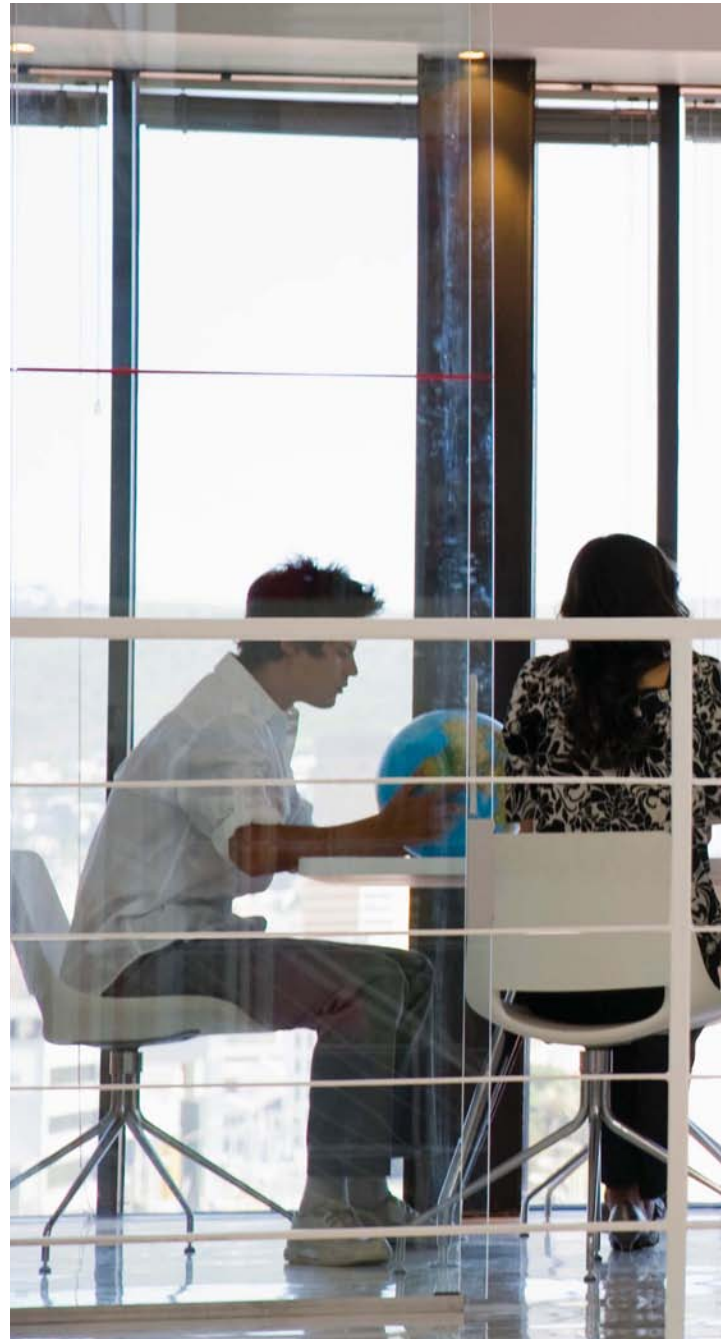
**2. Have you made any changes to the corporate structure?**

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.

**3. When did you last determine the value of the business?**

Determining the value of a business is a complex process that requires outside expertise. Often shareholders of private corporations have a good idea of their company's value. However, a formal determination by a professional is required for the shareholders' agreement, as it may be used in the application of several provisions.

Since the value changes over time, this should be reviewed on a regular basis and agreed upon by all shareholders. When enforcing the agreement for the purpose of redeeming or purchasing the shares of a shareholder, it may be that the value determined in the agreement is no longer valid. To address this problem, it is a good idea to plan the approach to be taken for the valuation.



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.

**4. Have you considered shareholder illness or death?**

Where there is an age gap between shareholders, a share redemption clause is sometimes provided in the agreement to take effect in the event of the death of the oldest shareholder.





This is most often the case when there is an older majority shareholder or a much younger minority shareholder. Since the value of the youngest person's shares is much lower, and thus considered less problematic, these clauses do not provide for redemption in the event of the younger person's disability or death.

The redemption clauses and mechanisms may vary considerably from one shareholder to the next. What's more, the redemption and purchase mechanisms upon death must reflect the wishes of the shareholder, as stipulated in his or her Will. However,

testamentary provisions must be drafted in keeping with the shareholders' agreement. For example, can the shareholder leave his or her shares to heirs? Are the shares redeemed automatically by the corporation?

#### **5. 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.

#### **6. Could your agreement benefit from the grandfathering provisions related to the stop-loss-rule?<sup>1</sup>**

Prior to February 26, 1995, a shareholders' agreement funded with life insurance

benefited 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.

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.



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



## 7. Does your shareholders' agreement consider tax opportunities and restrictions?

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

Tax elements not to be overlooked when drafting a shareholders' agreement should include (among other things):

- 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 liquidator to ensure that the tax rules in force at the time of death can be optimized.

## 8. 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.

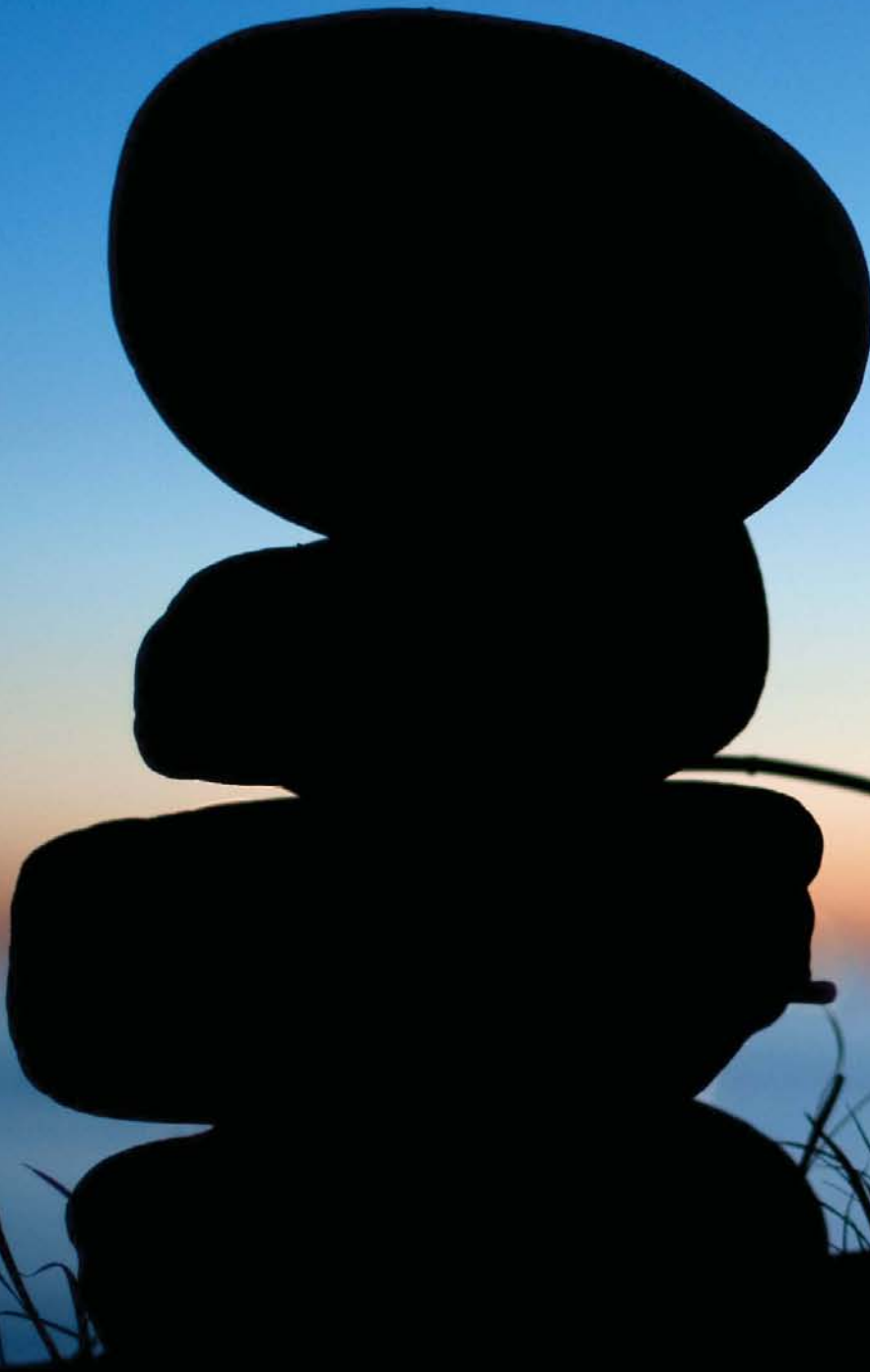
It is important that each shareholder, as well as his or her spouse, review their personal planning and legal documents, including their Wills and Powers of Attorney, with the help of a qualified legal professional. These documents should be revised, as necessary, based on the relevant provisions contained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

While these points provide a solid starting point for revising and updating a shareholders' agreement, it's important to consult tax and legal experts who specialize in the preparation of such documents. A well-drafted shareholders' agreement will take into consideration the economic, legal and personal reality of each shareholder, as well as the specifics of the business itself. ❖

<sup>1</sup> 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 per cent of the dividends used for the redemption of shares were tax-free capital dividends. Subsection 112(3) of the Income Tax Act.



Is incorporating your professional practice **right for you?**







**O**ver the past decade, every Canadian province and territory has enacted legislation that allows professionals to obtain the same tax advantages as other small business owners. These tax-related advantages stem from the ability to incorporate and the ability for family members to own shares. When considering incorporating your professional practice, there are a number of benefits, primarily tax advantages, to think about. At the same time, there are disadvantages of which you should also be aware.

#### **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 now allowed in every province and territory across Canada. In each, the professional regulatory body usually determines whether its members may incorporate. For example, the regulatory body for physicians, in all provinces and territories, allows physicians to incorporate.

#### **How it works**

In many, but not all, provinces and territories, only members of the same profession can be voting shareholders. Each profession, by province, has specific rules as to who can hold the shares of a professional corporation. For example, these rules could state whether the shares can be held by a holding company, family members or a family trust. The officers and directors of a professional corporation must generally also be shareholders of the corporation and the professional corporation is usually subject to the investigative and regulatory powers of its regulatory body. Lastly, note that a professional corporation will not protect a professional against personal liability for professional negligence.

#### **Tax advantages**

There are several tax advantages available to professional corporations that are not available to professionals who work as sole proprietors. These include the opportunity to defer taxation by leaving money in the corporation and the tax savings that can result from the lower corporate tax rate, the ability to draw dividend income from a corporation and the opportunity to income split after-tax corporate earnings by paying dividends to adult family members who are shareholders of the professional corporation.

### Potential tax deferral

Perhaps the most significant advantage of using a professional corporation is the ability to defer taxes. Professional income earned through a corporation is taxed at two levels — once at the corporate level and then again at the shareholder level when the profits are distributed as dividend income. Since income at the corporate level is taxed at a lower rate than personal income, a tax deferral opportunity exists when the income is taxed in the corporation (at the lower rate) and is not distributed to the shareholder. However, the deferral ceases when a dividend is paid to you and you pay the tax on that dividend.

Let's illustrate. If you earn a professional income of \$500,000 per year as a sole proprietor and only need \$300,000 of pre-tax income for personal expenses (including taxes), you will be left with \$200,000 that will be taxed at the highest marginal rate. Assuming a marginal tax rate of 47 per cent, you will be left with \$106,000 to invest.

On the other hand, if you incorporate the practice, the \$200,000 will be left in the corporation and taxed at the small business rate. Assuming a corporate tax rate of 18 per cent, the corporation will be left with \$164,000 to invest. That's \$58,000 more that could be used to pay off debt, purchase capital assets, acquire investments or fund an insurance policy, among other things.

	Sole proprietor	Professional corporation
Income	\$500,000	\$500,000
Personal needs (including taxes)	(\$300,000)	(\$300,000)
Remaining funds	\$200,000	\$200,000
Taxes	(\$94,000)	(\$36,000)
Net funds	\$106,000	\$164,000
Additional funds in the professional corporation	<b>\$58,000</b>	

### Potential tax savings – combined corporate and personal taxes

Another advantage is tax savings. A reduced federal and provincial corporate tax rate applies to the first \$500,000 of active business income earned by a professional corporation. Manitoba and Nova Scotia apply the reduced provincial tax rate on the first \$400,000 of active business income. For 2012, the combined federal and provincial tax on income subject to the small business rate ranges between approximately 11 per cent and 19 per cent. As a result of this lower rate, the combined corporate and individual taxes paid on the first \$500,000 of professional services income earned through a corporation is generally lower than if you earned this income personally. Prince Edward Island and Quebec are exceptions to this rule.

For example, if a doctor in Ontario asked his advisor to quantify the potential tax benefits of a professional corporation using RBC's *2012 Professional Corporations Decision Tool*, he would get the following calculation:

If the doctor earned \$500,000 in 2012 as a sole proprietor (with no other income), he would be left with \$288,421 of after-tax income in 2012. Through a professional corporation, the same \$500,000 would result in net after-tax corporate income of \$420,810 (assuming the only incremental cost is \$2,000 annual compliance cost). If the corporation distributed the 2012 after-tax corporate income as dividend income in 2012 and incurred tax at the shareholder level, the doctor's after-tax income would be \$304,220, resulting in tax savings of \$15,799.

### Potential tax savings – income splitting

You may be able to split income through a corporation by paying dividends to adult family members who are shareholders of the corporation. This strategy may be less applicable to professional corporations situated in provinces where share ownership is restricted to members of a particular profession, for example, lawyers and accountants in Ontario. However, other income-splitting strategies, such as hiring family members to work in the business and paying them a reasonable salary for services rendered, are still available through a professional corporation. Paying your family members a reasonable salary for the services they provide could also provide them with RRSP contribution room and enable them to make CPP contributions.

In our example on page 20, the tax saving available through the use of a corporation was \$15,799 where the professional is the only shareholder of the corporation. Using the same tool, the advisor was also able to quantify the following:

If a spouse is added as a shareholder and after-tax corporate income is paid out as dividends and split 50/50 with the spouse (\$210,405 each) then the total after-tax income for both is \$324,688 resulting in a tax savings of \$36,267 compared to earning professional income as a sole proprietor. Similarly, if two adult children are added as shareholders and the corporate after-tax income is split four ways (\$105,202 each) then the total after-tax income for all four is \$365,124. The resulting benefit is \$76,703 compared to earning professional income as a sole proprietor.

The following table summarizes the above scenarios.

After-Tax Income Summary						
	Total tax savings*	Total after-tax income	Client	Spouse	Adult child #1	Adult child #2
Scenario #1 – Sole Proprietor		\$288,421	\$288,421			
Scenario #2A – Professional Corporation	\$15,799	\$304,220	\$304,220			
Scenario #2B – Professional Corporation – 2 shareholders	\$36,267	\$324,688	\$162,344	\$162,344		
Scenario #2C – Professional Corporation – 4 shareholders	\$76,703	\$365,124	\$91,281	\$91,281	\$91,281	\$91,281

\*Total tax savings compared to earning professional income as a sole proprietor under Scenario #1

The chart illustrates the potential annual tax benefit of splitting professional income through a corporation by paying dividends to adult family members who are shareholders of the professional corporation (where permitted). Keep in mind that for this to work, the recipients must be in lower tax brackets. The above examples also illustrate the maximum tax savings available as it assumes the recipients have no additional sources of income other than the dividend income from the professional corporation.



### Potential tax savings – capital gains exemption

Canadian tax rules permit that up to \$750,000 in capital gains arising from the sale of the shares of a qualified small business corporation (QSBC) may be exempt from tax. If a professional corporation qualifies as a QSBC, this \$750,000 capital gains exemption is also available upon the sale of the shares. Therefore, incorporating your practice enables you to sell your interest in the practice as shares, which means up to \$750,000 of tax-free capital gains. In fact, for members of certain professions, for example, the medical profession in all provinces and territories, it may be possible to access more than \$750,000 in tax-free capital gains by having other family members own shares of a professional corporation. However, the ownership of a professional corporation may not be as easily transferable since, in many provinces, it can only be transferred to members of the same profession.



### Other advantages

Although the primary benefits of incorporating a professional practice are the tax advantages that are available, other benefits of incorporation include:

- **Flexible employee benefits** – access to certain types of employee benefits that would otherwise not be available if you were a sole proprietor or a partner in a partnership, such as membership in an Individual Pension Plan (IPP) and Retirement Compensation Arrangement (RCA).
- **Flexibility in remuneration** – the option to receive a combination of salary, bonus and dividends from a professional corporation.
- **Limited commercial liability** – the same protection as other corporate shareholders when it comes to trade creditors.

### Disadvantages of a professional corporation

It is important to understand that there are also drawbacks to operating a professional practice in a corporation. These include:

- **Costs and complexity** – costs for establishing and maintaining a professional corporation are usually higher than those of a sole proprietorship.
- **Employer health tax and Employment Insurance (EI) premiums** – corporations in several provinces have to pay a provincial health tax levy once the corporate payroll has exceeded a certain threshold.
- **Business losses** – you cannot claim business losses incurred by a professional corporation on your personal tax return; whereas, in a sole proprietorship, you may use the business losses to offset your personal income from other sources.
- **Personal use of corporate funds** – by incorporating your professional practice, you cannot use corporate funds for personal expenses unless you first get the money out of the corporation using a legitimate method such as paying salaries, bonuses or dividends.

It is important to understand that there are also drawbacks to operating a professional practice in a corporation.



The most significant advantage to a professional corporation is clearly the potential tax savings and deferrals, which can be very appealing if you do not require all your income to live on.



- **Association** – be aware of association rules if you have other family members who have corporations that qualify for the small business deduction (SBD). This can cause problems if you have ownership in their corporation or they have ownership in your corporation. In this context ownership refers to direct ownership or indirect ownership, for example, through a trust. If corporations are associated, they have to share the SBD, which may not be desirable.
- **Liability for malpractice** – a professional corporation will not protect you from personal liability for professional negligence.
- **Period of existence** – a professional corporation may have a much shorter existence than a regular corporation since the voting shares generally have to be owned by individuals who are members of the same profession and the corporation may not carry on business other than the practice of the profession.

#### **Weigh the pros and cons**

The most significant advantage to a professional corporation is clearly the potential tax savings and deferrals, which can be very appealing if you do not require all your income to live on. They can also be advantageous if you wish to save for your retirement through alternative vehicles such as an IPP or RCA, or if you want to limit your personal exposure to commercial liability. Consider the advantages and disadvantages of incorporation carefully and consult a tax advisor if you are considering setting up a professional corporation. ❖

# MINIMIZE TAX AND MAXIMIZE YOUR BUSINESS SALE

**T**here are 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 that 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.

#### 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 referred to as an “estate freeze.” This strategy can allow for a multiplication of the \$750,000 lifetime capital gains exemption (CGE) among family members on a future share sale of a qualifying small business corporation (QSBC). Every person has a lifetime \$750,000 CGE 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.

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 \$750,000 CGE, so advance planning in this case is important.

Other criteria to qualify for QSBC status are that throughout the 24-month period prior to the sale, at least 50 per cent 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 per cent of the assets must be used in the active business in Canada. If you have accumulated passive investment assets in your company, then there are strategies to restructure your business so the passive assets do not disqualify your

shares from QSBC status and prevent you from claiming the maximum \$750,000 CGE. 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 \$750,000 CGE and also to multiply the CGE with other family members, speak to your tax advisor to determine if you should “crystallize” your CGE 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 CGE 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 CGE 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 any remaining \$750,000 CGE. In this case, the shares do not have to be held for at least two years to qualify for the CGE.

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 \$750,000 CGE. As a result, you might be able to negotiate a higher sale price so the after-tax proceeds of an asset sale are similar to a share sale.

However, asset sales can be very attractive if the majority of the assets being sold are considered “goodwill.” In this case, only 50 per cent of goodwill is taxable in the corporation at active business tax rates and the other 50 per cent can be paid out of the corporation to you tax-free. This could result in a maximum tax rate on the goodwill portion of the sale proceeds of only 12-15 per cent (although some of the proceeds remain in the corporation tax-deferred) compared to a maximum capital gains tax rate of 20-25 per cent on a share sale.

There are some more sophisticated tax strategies that may allow you to claim both the CGE 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 CGE. As previously mentioned, if there are passive assets in the corporation such that less than 90 per cent 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 CGE. 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 CGE on a QSBC share sale, you may be able to effectively receive some of the sale proceeds tax-free into a holding company instead of paying tax currently at capital gains tax rates. This strategy is called a “safe-income strip.” The portion of the proceeds that can be received tax-free into your holding company will depend on a tax calculation relating to the active corporation’s prior year’s retained earnings for tax purposes. 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 your capital gains tax.

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. Every two dollars donated will eliminate one dollar of tax on the sale of the business. However, 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 (received tax-free at cost). 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, goodwill).

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 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 must 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. With the up-front tax deduction, the investment value can usually decrease by about 30 per cent and you will still break-even. Keep in mind that in some cases, there is an 18-24 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 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.

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



## 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 2011, then net capital losses in 2012, 2013, or 2014 can be carried back to 2011 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 2011 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 an 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. ❖



# Life after death for your business

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 Carolyn Cook, Financial Advisory Consultant, 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 health care 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 your professional legal advisor about the documentation that 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 Carolyn. "This can be important whether you are the sole proprietor of an unincorporated business, a partner in a partnership, or an owner or director of an incorporated company."

### **Who should you appoint as your attorney?**

In considering your business, ask yourself who would be appropriate for this role. Should you appoint multiple attorneys and if so, how do you intend for them to work together? Consider appointing an individual or individuals to act on your behalf who could operate effectively in your business and with the cooperation of directors, shareholders, partners, employees or other staff members who may be involved in the 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 fulfil their duties? Should you compensate your attorney? If so, how much? Can your attorney delegate his or her authority? Discuss these questions with your professional 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 illness or incapacity, you can also choose to have this document take effect in various other situations. For example, you may wish to have your attorney act 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 effect if you become physically incapacitated. At such a time it may be impractical 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.

Another option is to provide that your Power of Attorney will not become effective until you are incapable of managing your finances. If you wish to have the Power of Attorney take effect in such a case, for example, when a specified event occurs, ensure your lawyer is aware of your intention and clearly define what the triggering event will be. In cases where the document comes into effect on your 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 choosing your attorney, also consider what you may want him or her to do. 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.

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 do so:

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

If you have an incorporated company, there are some additional matters to consider when creating a Power of Attorney and deciding who to appoint as your attorney. Will your attorney need to act as a director of your company at some point? Also, check to see whether the attorney you wish to appoint also has an incorporated company. If they do, there may be consequences that you did not intend.

Powers of Attorney may not be accepted at RBC to authorize your attorney to conduct transactions on non-personal accounts. If you wish your attorney to perform transactions on your behalf on your non-personal accounts, consult your professional legal advisor regarding the documentation that may be required.

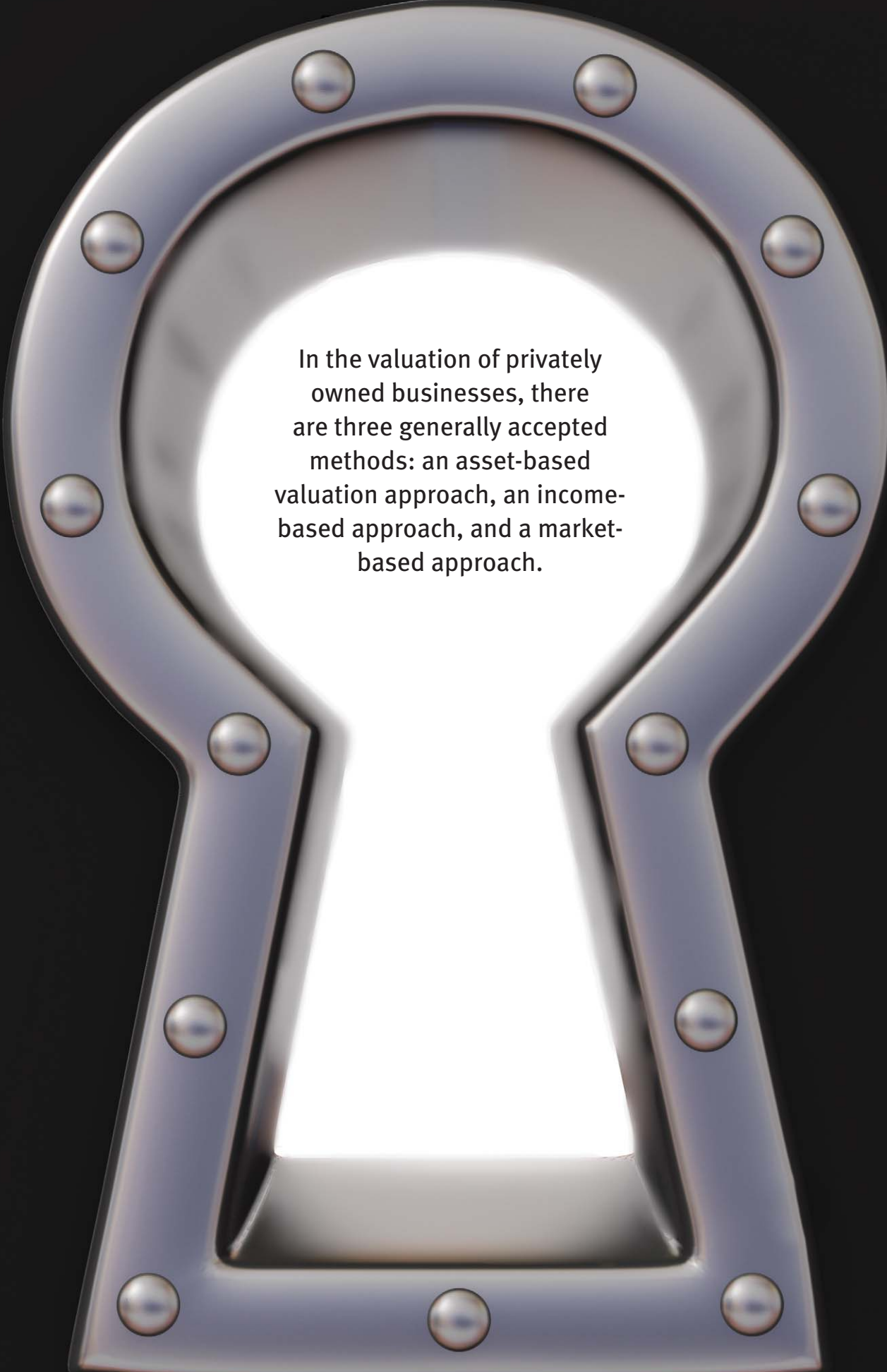
### Acting as a company director

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. However, 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 a 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 them. If there are other corporate shareholders, your attorney will 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.

### 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 benefited. 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. ❖



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.

# Selling your business? Make sure you know its value beforehand

The Family Firm Institute estimates that about one-third of Canadian family entrepreneurs are planning to hand over the company within the near future.<sup>1</sup> However, how does a business owner determine if a purchase offer is reasonable? Simple. They have to know the value of their business.

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.

## Asset-based valuation 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.
- Where the value of the business is attributable to the current owner's personal attributes or relationships and is not transferable to a potential purchaser. 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.
- 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 purchaser is interested in acquiring the business's future earnings or cash flows. This approach is appropriate

<sup>1</sup> Family Firm Institute, "Global Data Points"  
<http://www.ffi.org/?page=GlobalDataPoints>





The capitalized earnings approach is appropriate for valuing a mature, established business.

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's 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 that 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.

- 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 potential purchaser on his or her investment in the business. For example, a purchaser requiring a return of 20 per cent on their 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 potential purchaser will require changes over time and according to the situation, and will reflect the risk of the particular investment being analyzed.

A potential 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 capitalized value. The capitalized 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 the capitalized 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 require compensation from the purchaser for the fair market value of these redundant assets.

The total of the capitalized 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.<sup>2</sup>

### 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 that 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 per cent of the common shares of Company A (which has no debt), with an EBITDA<sup>3</sup> of \$2 million, and using a multiplier of 5, was acquired for \$10 million; and
- 100 per cent 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 capitalized value of her business by multiplying her business's 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.

<sup>2</sup> This is only done if interest expense has not been considered in determining maintainable earnings.

<sup>3</sup> EBITDA is a financial metric reflecting a company's earnings before interest payments, amortization and taxes.

Determining the fair market value of a business 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.

In the public company multiple approach, a business is valued based on the valuation multiples derived from the market capitalization<sup>4</sup> 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 a market capitalization of \$132 million; and
- Company B, with annual sales of \$60 million, has a market capitalization of \$48 million

The average sales multiple implied in the market capitalization of 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 per cent discount is appropriate. The owner could then determine the capitalized value of his business by multiplying his business's most recent maintainable sales by 0.42, the average implied sales multiple in the two public companies, less a 45 per cent 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.



In an actual sale, potential purchasers may be willing to acquire a business for a price that is different from the business's 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's 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. ❖





<sup>4</sup> Market capitalization of a public company is calculated as follows: current share price multiplied by the number of shares outstanding.







# 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 also be 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 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 – whether it be that of ideas, technology or credit – has been fundamental in the success and creation of wealth for many high-net-worth individuals – particularly for business owners,” says Mary Holenski, Head, RBC Canadian Private Banking.

“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 of Credit with RBC Wealth Management, Private Banking, who

works with executives and business owners in Calgary. “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 Marian, “and that we explore the client's goals and strategies and dig below the surface to ensure our understanding is complete.”

For the business owner, 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.

Marian 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 toward 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 Canadian Private Banking, 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 Robert. “The strategies range from the 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 the 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.

### 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 Robert. “Ideally the proceeds of credit are used for investing and building wealth, as opposed to personal consumption.”

### 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. ❖

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







# Equipping your business for **success**

As economic conditions change and new business opportunities arise, one of your ongoing challenges as a business owner is ensuring you have the right equipment or machinery – including technology – to meet your changing circumstances. Part of your challenge is determining when you should invest in new business equipment to support your long-term strategic goals. For a number of reasons, now is a good time to consider making this investment.





### Why now?

“Whenever economies are coming out of recession and expanding, that’s a great time to be thinking about investing in business equipment,” notes Bruce Pennington, Vice-President, Equipment Finance, RBC Royal Bank. “Compared to historical levels, the Canadian dollar is very high relative to the U.S. dollar, and capacity utilization is still low. While this might be slowing growth, it also brings opportunities to negotiate better prices on equipment, allowing business owners to save valuable upfront cash for other uses.”

From health-care professionals, architects, engineers and other business professionals, to business owners at either end of the supply chain, businesses small and large constantly face the challenge of keeping their equipment up to date. For many of these businesses, ever-evolving computer technology is the most difficult to keep on top of, even though cutting-edge technology can be crucial to their success.

“There is no longer a question of whether we need technology to be competitive in today’s retail world,” the Retail Council of Canada advises its members. “The only issue in this area is which system will give you the best return on your investment.”

Your investment timing is also critical. Investing in new equipment now will help position your business favourably against any competitors who don’t make the same investment choices.

### Building your business case

So, the timing appears to be right for businesses in general to be investing in new equipment – but is the timing right for you?

Bruce advises that the best way to make a business case for investing in new equipment, whether by purchasing or leasing, is to consider a number of factors.

“First of all, what is your strategy as a company? Where do you want to be? What are your short- and long-term goals? Are you happy with the market position you presently have, or are there new markets you want to pursue? Is existing equipment obsolete or inefficient? What is your market position?”

“Take a look at those factors, and then take a look at the outside world again,” Bruce continues. “What are your competitors doing? What is the economic climate?”

### Here are six questions to ask yourself as you consider whether acquiring new equipment would be right for your business:

1. Will new equipment help you increase productivity and/or efficiency and the profitability of your business?
2. Is your business as large and as successful as you want it to be?
3. Will investing in new equipment be an investment in the core part of your business?
4. Will such an investment be a good fit with your long-term objectives?
5. Will new equipment help you keep ahead of – or keep pace with – your competitors?
6. Can you afford not to invest in new equipment?

As you work through all those components, think about any contingencies and crunch the numbers. Get external advice from people you trust – your accountant, your financial advisor, your banker – because they will provide a more comprehensive outlook and bring a different perspective to the questions you have.

### Match equipment needs to financial means

Matching your equipment needs to your financial means is critical. All the external elements may be in place, but you need to be confident your business can handle the investment, advises Jim Hart, Senior Manager, Client & Business Strategy, RBC Royal Bank.

“Many businesses have had to make adjustments to lower sales levels in the last year or two. Do you have the financial capacity to make the investment? Is there a business case for the new expenditure, either through cost savings or revenue generation? While you have to ask yourself these critical questions, don’t avoid making an investment just because times have been tough recently. Now, more than ever, Canadian businesses need to look forward.”

“All businesses have only a certain amount of capital to invest,” adds Dave Majeski, Vice-President, Real Estate and Construction Services, RBC Royal Bank. “The real decision here is should you invest in equipment or land and buildings? If you invest in equipment, you may have to significantly



increase your revenue and diversify your income stream, while improving cash flow to service debt or leasing costs. You really need to look at what your core business is and how your investment will improve your return.”

To make the right kind of financial decision about any kind of investment, it's important to look at all of the factors that impact your business. It's also important to validate your thinking – contact people who understand your business and discuss the long-term impact new equipment will have on your operations. The more information and advice you seek, the more informed your equipment investment decision will be.

### Financing options

Most small- and medium-sized businesses require financing to achieve their goals, regardless of whether they are new ventures or existing operations. Long-term debt covers purchases that usually take more than one year to repay – this includes equipment. By using long-term financing to fund long-term asset investments, you can preserve your cash and liquid business assets to fund day-to-day expenses.

### Term loans

If you're certain you want to own the new piece of equipment you're interested in, but don't have the cash on hand to do so, one financing option is a term loan. Your monthly payments will usually be higher than lease payments, but you will own the equipment outright and pledge it as security for the loan.

Term loans help avoid tying up your cash flow or existing credit line. Term loans are secured using your existing assets as security. They typically last for up to seven years, but not longer than the useful life expectancy of the piece of equipment you are buying.

A term loan requires regular payments over a fixed time period – typically monthly – at a set or variable interest rate that is based on your bank's prime lending rate. Fixed rate loans typically start at \$10,000; variable rate loans typically start at \$5,000. The regular payments make it easy for you to forecast your cash flow, and by matching the term of the loan to the expected lifespan of the equipment in which you're investing, term loans effectively pay for themselves over time.

### Leasing vs. buying

	Lease	Buy (with loan financing)
<b>Down payment</b>	None. Up to 100% financing including applicable taxes.	10% to 25% of value.
<b>Collateral</b>	Generally only the leased equipment is pledged.	Purchaser may be required to pledge other assets to support borrowings.
<b>Payments/cash flow</b>	Lower monthly payments; usually includes a purchase option at the end of the lease term.	Higher monthly payments, but has the advantage of outright ownership. The equipment is pledged as security for the loan.
<b>Obsolescence</b>	Lessor may assume ownership at the end of the lease, unless the option to buy is exercised by lessee.	Purchaser owns the equipment and must deal with any obsolescence issues.
<b>Term, amortization and interest rates</b>	Both leases and loans are available in a wide range of terms. Duration of agreement generally is subject to negotiation based on the useful life of the equipment financed. Interest rates are also negotiable, but influenced by the general rate environment.	
<b>Tax implications</b>	Rentals may be 100% tax deductible.	Depreciation (CCA) and interest expense may be tax deductible.

The tax rules and cost benefits relating to equipment financing can be complex, so it's wise to consult with your accountant before making any major equipment purchase or committing to a lease.

### Leases – capital and operating

Some firms limit their long-term debt by leasing equipment instead of buying it. You do not own the equipment you lease, but generally the monthly payments are lower than loan repayments.

There are two types of leases: capital and operating. A capital lease is generally used to finance equipment for most of its expected lifespan and usually includes a pre-arranged buy-back provision so the equipment can be purchased when the lease expires. An operating lease usually finances equipment for less than its expected useful life; at the end of the lease, the equipment can be returned without further obligation.



For businesses that rely upon being as cutting edge as possible, leasing with an option to buy offers a chance to try out the latest equipment to see how it fits in with long-term plans before committing to any purchase.



Leases can be structured so they include maintenance, upgrades and other services. The negotiated length of the lease is also important. A five-year lease makes sense, for example, if your equipment is expected to last up to 10 years, but not if this equipment will become obsolete within three years. Technology in particular goes out of date very quickly. Leasing offers a way to keep upgrading your technology on a regular basis as each lease ends.

So now, with those financing options and the new equipment you want in mind, do you buy or lease?

### Buy or lease?

American industrialist J. Paul Getty had a very straightforward buy-versus-lease philosophy: If it appreciates, buy it. If it depreciates, lease it.

Today's guideline when investing in equipment is: Equipment that won't readily become obsolete is something you might want to own, while equipment based on cutting-edge technology is something you might want to lease.

The immediate benefit of buying the equipment you want to invest in is that you own what you buy. So, if the equipment you want to acquire is expected to have a long lifespan and is not likely to become obsolete, ownership is a good option to consider. If the equipment you purchase doesn't end up suiting your long-term needs, you can resell it.

As well, any company investing in equipment by purchasing it outright increases the value of its business. This can make it easier to apply for new loans as the new equipment becomes valuable collateral.

There are disadvantages to buying new equipment, however. The higher initial expense could put too much of a strain on

your cash flow; borrowing to make the purchase could impact your line of credit and future financial flexibility. Owning your equipment also, of course, means you're responsible for ongoing maintenance and repairs, or there might be additional costs for a service contract or warranty.

### Lease or buy?

Leasing is another option that, depending on the type of business you operate, can offer you a way to maximize your business opportunities while minimizing your operating expenses – your cash flow is preserved for other needs. For businesses that rely upon being as cutting edge as possible, leasing with an option to buy offers a chance to try out the latest equipment to see how it fits in with long-term plans before committing to any purchase. Leasing is a way of paying for the use of capital assets (such as production equipment, computers and vehicles) as they generate revenue for your operations.

There also are disadvantages to leasing. As you don't own the equipment you lease, you have no equity in it. A lease commits you to a set payback period. If your needs change before the lease expires, unless other provisions are included in your lease agreement, you will likely have to continue making payments until the lease ends, regardless of whether or not you are continuing to use that piece of equipment.

When you have a specific piece of equipment in mind, you can see what the financial comparisons look like between leasing and buying by checking out the interactive online Lease or Buy Calculator at [www.canadabusiness.ca/eng/page/calc](http://www.canadabusiness.ca/eng/page/calc). Provided by the Government of Canada on its Canada Business Network website, this calculator offers a direct cost comparison of buying versus leasing, including tax implications.

And if you want to find out how much a loan might cost to cover the purchase of new equipment, check out the interactive calculator at [www.rbcroyalbank.com/cgi-bin/business/loan\\_calc/loans.cgi](http://www.rbcroyalbank.com/cgi-bin/business/loan_calc/loans.cgi).

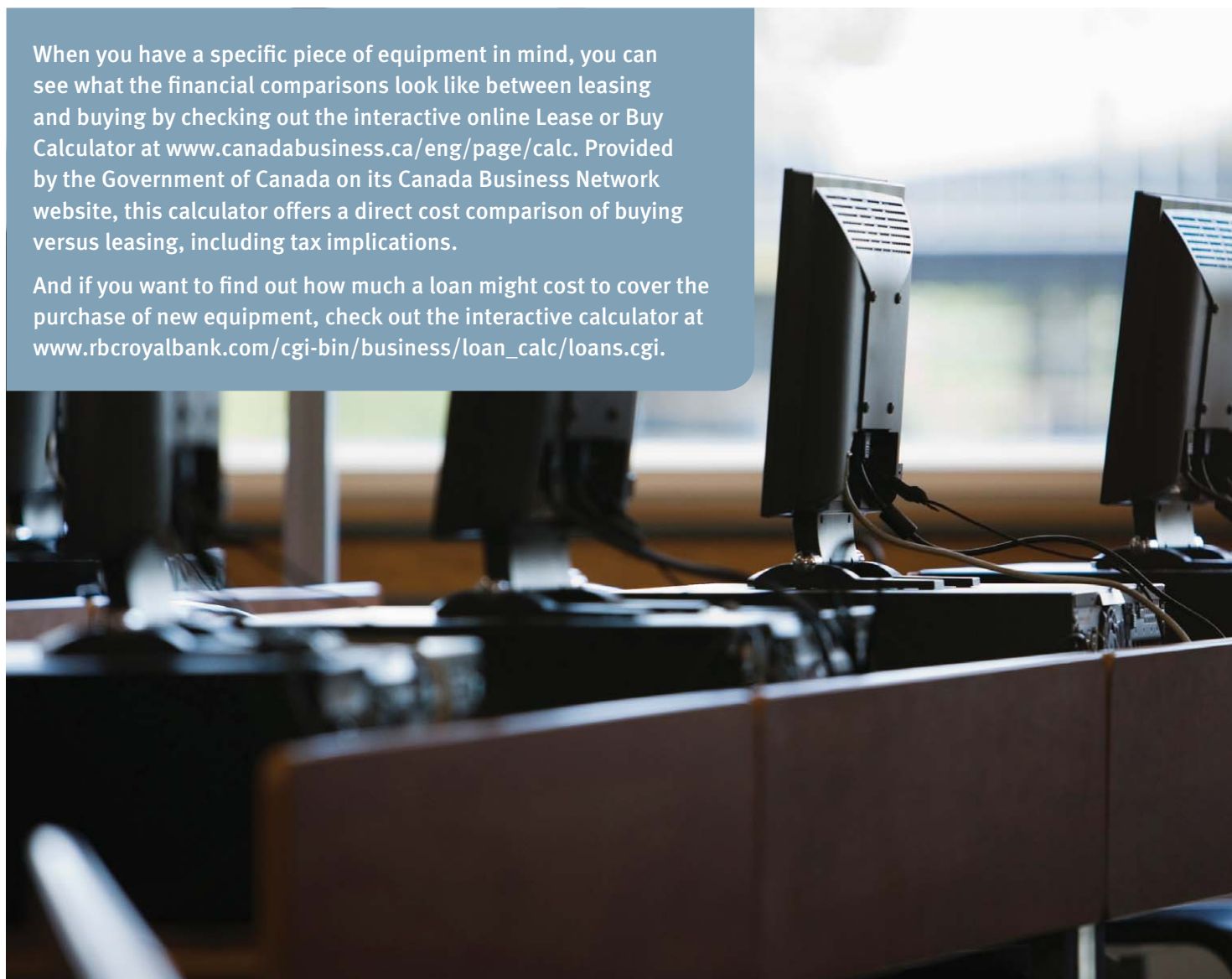
### The bottom line: Business sustainability

“Whether buying or leasing new equipment, like any business decision, you have to weigh the options in terms of your particular circumstances,” says Jim Hart. “None of this is a matter of right or wrong. Often, the choice between a lease or loan comes down to your specific tax situation or the deal you are able to negotiate.”

“The bottom line for me is the sustainability of the business – what does investing in new equipment do for the business in terms of my strategic objectives and overall productivity,” adds Bruce Pennington. “We think right now is a great time for Canadian businesses to make an investment in their long-term success.” ❖

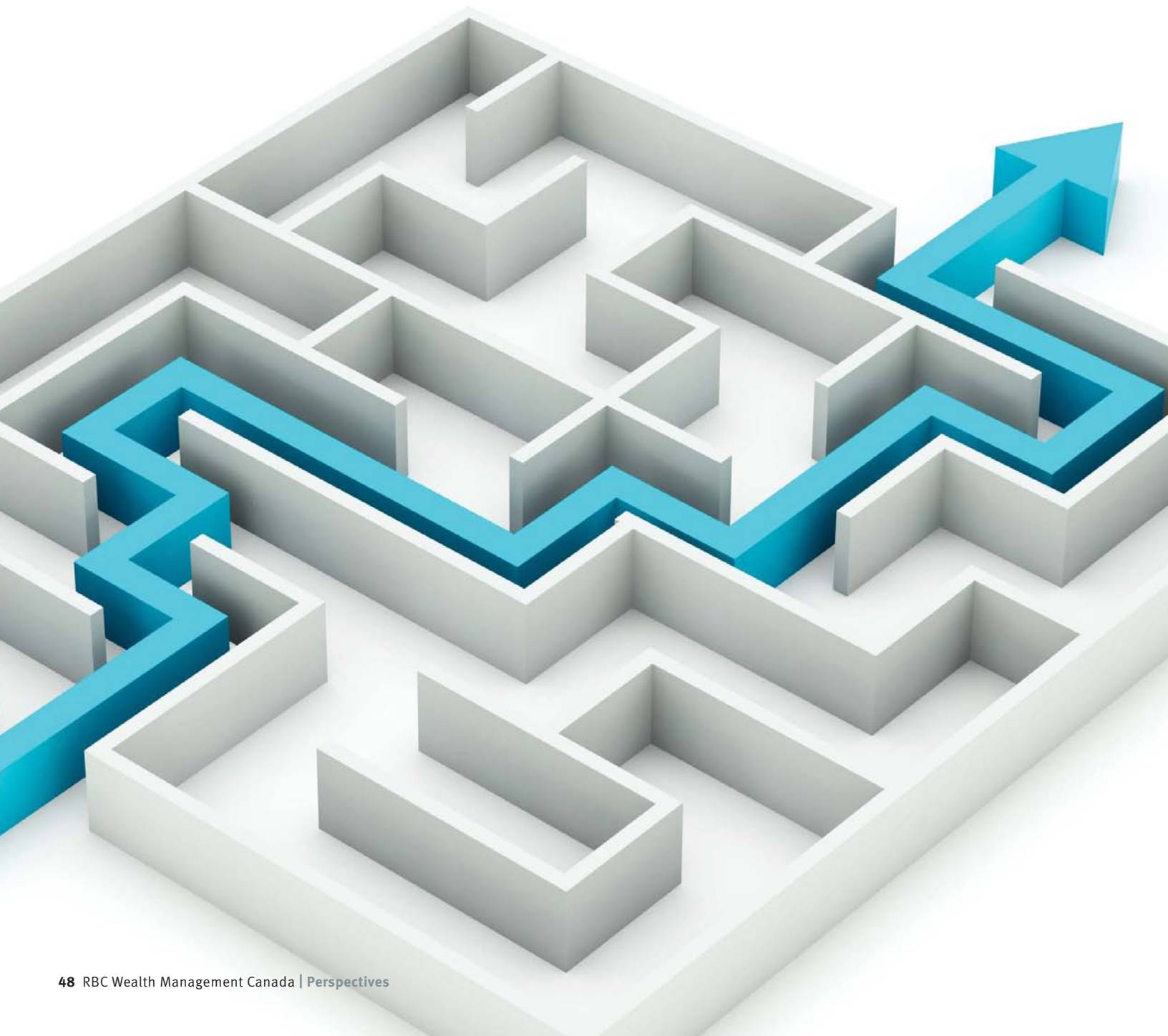
When you have a specific piece of equipment in mind, you can see what the financial comparisons look like between leasing and buying by checking out the interactive online Lease or Buy Calculator at [www.canadabusiness.ca/eng/page/calc](http://www.canadabusiness.ca/eng/page/calc). Provided by the Government of Canada on its Canada Business Network website, this calculator offers a direct cost comparison of buying versus leasing, including tax implications.

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# Your business **EXIT** strategy

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





A number of studies published over the last few years have indicated a wave of business transfers coming in the future. While some business owners have given this considerable thought and have a fully developed succession plan in place, many others have not given it much consideration. A prudent business owner should be aware of common exit options, some of the practical issues associated with each option and common problem areas that may require improvement prior to the sale of a business.

### Exit options

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

- 1. Selling or transferring to parties related to the business, such as a family member, management team or another partner or shareholder.**
- 2. Selling to third-party buyers, which can include strategic buyers, financial buyers and other interested parties or serial entrepreneurs.**

“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 Corporate Finance. “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 chosen by an owner who wants to see the business continue in a similar fashion within the family. If done well – and seamlessly – one of the benefits of this approach is a lesser chance that there will be a negative reaction 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.

Choosing the right successor will generally have a significant impact on the future success of the business and, potentially, the family’s overall wealth. Frankly, 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. There may not be a person with that skill set 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 Paul. “Human resources consultants can be engaged to evaluate the capabilities of the family members put forward and ultimately make recommendations based on their perceived suitability for the role. It helps take some of the emotion out of the decision for a family.”

Generally, transfers of companies within families often happen and can be a viable and attractive 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 their business. Selling to a MBO team can have many positive features and can be a relatively easy process versus dealing with third-party buyers.

The MBO team and the seller typically are very familiar with one another and recognize the win-win nature of the transaction. This can lead to fewer “hard positions” being taken and ultimately to an increased likelihood that the transaction will be successful.

A top management team will also have fundamental insight 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 easier. Finally, the transition risk is also minimized as the MBO team is already known to customers, suppliers and employees, and can 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. The equity component is considered the tough money to get. Internal buyers, whether a family member or a management team, will typically have access to limited amounts of personal cash. Therefore, in most small- to mid-sized companies that are considering an MBO, the vendor typically has to cooperate 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 fashion. The MBO team is a good exit option for a vendor who does not want to maximize all components such as value, cash proceeds on closing and deal terms when selling.

In the case of mid- to large-size companies, management teams will typically partner with private equity firms that can provide a significant portion of the equity component of the purchase price. While this can be appealing to a management team, if they can only contribute a small portion of the total equity required, they will in turn only receive 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 very small ownership position and limited upside. 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 their situation.

### **Partner/shareholder buyout**

Selling to an existing business partner provides the benefit of working with a known party and can generally lead to a quick closing. Unfortunately, any discord between partners can also create a long, drawn-out process. A common issue typically arises around valuation. However, a well-devised and up-to-date shareholder agreement will lay out the rules and basic steps to follow when transitioning any ownership interest.

Financing these transactions can be relatively easy. There are a number of factors that can impact a financial institution's willingness to finance the buyer (assuming it is 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 who is exiting the business. In the right situation, by leveraging the cash flow of the business, the buying partner can generate a significant return on their investment. This also benefits the selling shareholder as they can receive a significant portion of their sale proceeds in cash on closing.

### **Selling to external parties**

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

“If the business owner is attempting to get the highest and best offer for their business, engaging a professional to run the divestiture process will usually result in the best deal,” suggests Paul.

Selling to a strategic buyer typically represents a very good option for most business owners. Strategic buyers are often in the same or a similar business to the company being sold. As such, they understand the markets served and the associated risks, and have the potential to extract various synergies. Due to their competitive position in the marketplace, a strategic



## 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.

buyer is usually also in the best position to pay a premium for the company. The drawback with opting for a strategic buyer is the requirement to disclose confidential information to the potential buyer – who may in some cases also be a competitor.

On the other hand, financial buyers, or PEGs, are looking for businesses with quality management teams, a strong earnings history, good margins, a sustainable competitive position in the industry and attractive long-term prospects in which to invest. Often these buyers require the existing management

team to stay on after the purchase as they generally don't have a management team of their own to put in place. PEGs pose less of a confidentiality concern to a seller due to their professional approach. Also, it's less likely they have another investment in the industry.

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



### **Getting your business ready for sale**

There are a number of items every business owner should consider when preparing their organization for a sale. The most common factors to review and analyze are: the management team; the company's management information systems; the customer base; the timing of the sale; and cash flow.

### **Management team**

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, as this can increase the operating risk of the business and the potential that problems will arise if that key person leaves.



### Management information systems

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

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

### Customer base

“Customer concentration is one of the most common problems in businesses that we see,” says Paul. “If no action is taken to improve things then this may limit the divestiture options for the business – or, when the business is divested the value is low and the sale proceeds are paid out over time.”

A potential buyer is ideally looking for a growing and diversified customer base. A business that is heavily reliant on one customer or a small number of customers presents a substantial risk due to the potential that the business’s value will decline if a major customer leaves. Where possible, bring on new customers, expand relationships with existing customers and limit the growth of your largest customer. This can result in a higher quality business and improved value on sale.

### Timing of the sale

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

### Cash flow

“Companies that attract a higher multiple when sold generally have a high quality cash flow – consistent, recurring, high margin and growing – that is highly visible to the buyer,” says Paul.

Cash flow tends to determine value and the higher the quality of the cash flow the greater the value. There are a number of factors that impact the quality of the cash flow. One of the best ways to improve 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. Where possible, take steps to reduce or mitigate those risks. Anything that creates a sense of risk or uncertainty in the buyer’s mind will have an adverse effect on value. Once the offer arrives it is very difficult to make any meaningful changes to the business that will result in an improved value, so do it before. ❖

## Summing it up

When it comes to exiting a business, the statement “all situations are different” is very applicable. While there are a few options, as a business owner, understanding your goals and objectives can often guide your exit strategy in a specific direction. Generally speaking, if it is important to see the business continue in a similar fashion, or to pass it on to family, or to have the company name survive, it is more likely that this will be achieved if an internal buyer is chosen. However, if the objective is to maximize deal terms such as cash and structure, the business will likely be marketed to third party buyers.



W W A T



# Who cares about water?

## **We do...**

Do you remember the first time you saw a photograph of Earth taken from space? Were you surprised by how much blue there was? Water covers almost three-quarters of the Earth's surface and is one of the most important resources on the planet. In fact, nothing can survive without it. Humans can go without food for weeks, but we'll die in a matter of days without fresh water. Water is so much a part of our daily lives that we rarely think about it and often take it for granted.

# FER

Although we have lots of fresh water on Earth, it is still a finite resource. Think about this: there is only as much water today as there was millions of years ago, yet the world's population just hit seven billion and continues to balloon.

Water isn't always found in the places where people live either. Climate change is causing dry places to get drier and wet places to get wetter. Add to that pollution, which is putting our precious water resources at risk. Even though water is an amazingly resilient resource, it's getting harder and harder for water to clean and renew itself with all the new pollutants going into our lakes and rivers.

In a world where there are so many urgent humanitarian causes and serious environmental issues competing for our attention, water can get overlooked and it often takes a crisis for us to stop taking it for granted.

## So, who actually cares about water?

### **Not-for-profits and conservation groups do**

Fortunately, there are hundreds of not-for-profit organizations, large and small, with thousands of volunteers across Canada that have made it their mission to care about water. It shouldn't be hard to find one within your community, such as a local conservation authority.

### **Corporations, industry and municipalities do**

Many companies care about water too. Water is needed to produce almost everything we eat, drink and purchase. While some industries, such as agriculture, are obviously large consumers of water, others may not be so obvious. For instance, did you know that it takes over 3,000 litres of water to produce and care for a single pair of jeans over the course of its lifecycle? (This includes cotton production, manufacturing and washing at home.) Did you also know that it takes between 60 and 180 litres of water to make just one litre of beer? From growing the wheat and barley, to brewing, pasteurizing and shipping that litre of beer, water is the fuel that runs the factories. Companies that depend on water to produce goods and services are increasingly aware of the importance of managing their water use as efficiently as possible.





There are also entrepreneurial companies developing new products and technologies to help individuals, manufacturers and farmers use water more efficiently. These organizations are managing to balance a concern for water and the bottom line at the same time.

You can add municipalities to the list of those who care about water. In many regions, municipalities are not only responsible for delivering safe tap water to homes, they are also faced with huge energy costs to treat and pump that water to us.

## Who else cares about water?

### You and I do

Keeping a single 60-watt light bulb lit for 12 hours uses as much as 60 litres of water. So when you use energy, you're also using water. People who drive cars, text or watch television should care about water – as should anyone whose home or business is powered by electricity, oil, natural gas, coal or nuclear energy. It takes water to create energy – from pumping crude oil out of the ground, removing pollutants from power plant exhaust, generating steam to turn turbines, flushing away residue after fossil fuels are burned and keeping power plants cool. ❖

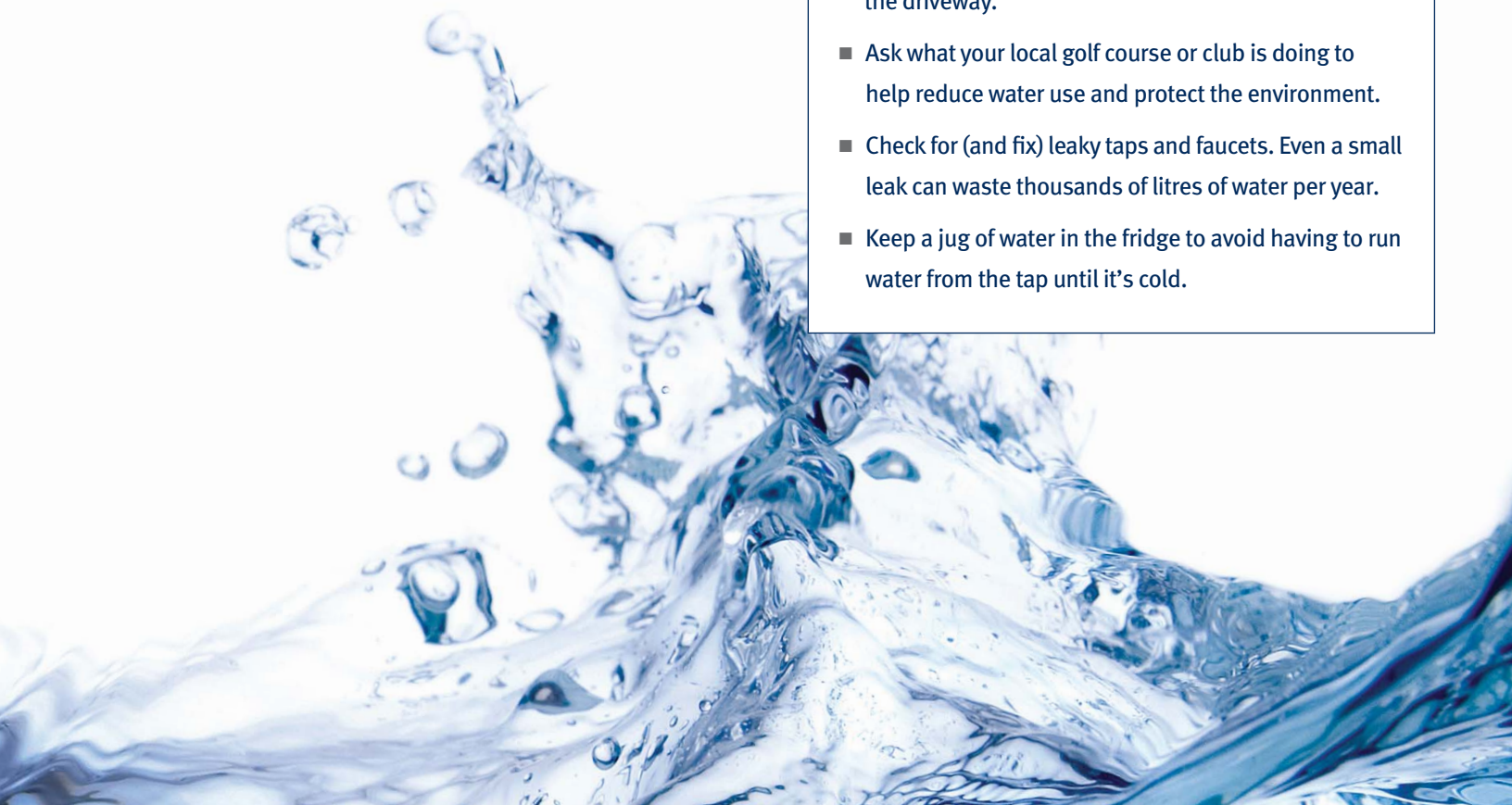
### RBC does

The RBC Blue Water Project is an innovative, wide-ranging, global commitment to help protect the world's most precious natural resource: fresh water. Since 2007, RBC has pledged over \$32 million to more than 450 not-for-profit organizations worldwide that protect watersheds or ensure access to clean drinking water. We're also promoting responsible water use with our employees and clients, reducing the intensity of our own water footprint and encouraging the growth of water businesses in North America. And it's because we care about water.

So, if you like to golf on a lush green course, enjoy a hearty Cabernet with your tenderloin, boat at the cottage or check email from your handheld device, remember that water helped make it possible.

### Five ways to show you care about water

- Plant a low-water garden. Attach a rain barrel to your downspout to collect water for plants, flowers, etc.
- Take your car to a car wash rather than washing it in the driveway.
- Ask what your local golf course or club is doing to help reduce water use and protect the environment.
- Check for (and fix) leaky taps and faucets. Even a small leak can waste thousands of litres of water per year.
- Keep a jug of water in the fridge to avoid having to run water from the tap until it's cold.







# 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 expensive to an organization, so give some thought to how you can motivate key employees and keep them focused on the company's priorities.

Group RRSPs are one way you can encourage your employees to save for retirement throughout their careers.



### 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 Saving Plans (Group RRSPs)

Group RRSPs are one way you can encourage 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 choose the investments within their individual plans, and the retirement benefit is based on the value of the investments in the plan when the employee retires. This can be a less costly option than a DB plan for you as an employer and is easier to administer.

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.

#### 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 have received. 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.

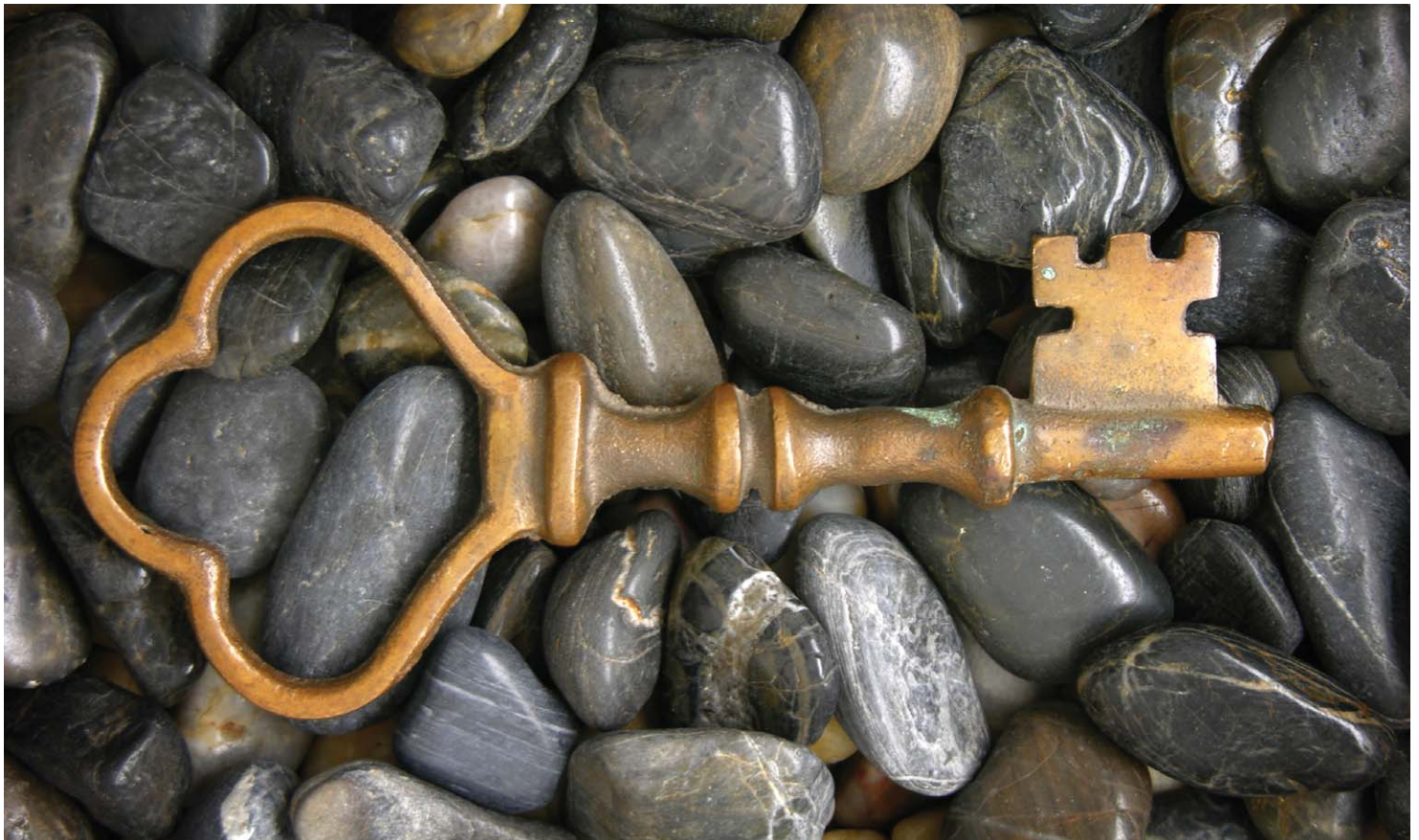


RCAs have no contribution limits (provided contributions are “reasonable”) and no investment restrictions. Employees may also be able to benefit from certain investment strategies involving life insurance. This can provide supplemental tax-exempt investment income and may yield better results than alternative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

alternative that enables your company to make larger annual contributions compared to an RRSP that is tax deductible to your company. IPP contributions increase with the age of the plan holder. If investment earnings in the plan are lower than expected, you may be able to make additional contributions. IPP assets may offer creditor protection and typically suit business owners, incorporated professionals or key employees who are age 40 or older and earn an annual salary of at least \$100,000. ❖



## 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 helps 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 their departure. Their dissatisfaction may indicate problems among other key employees and may save you from another costly loss.





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