Wealth Advisory 201: High Net Worth Opportunity

Business Succession Planning
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BMO Nesbitt Burns®

Larry H. Frostiak, FCA, CFP, TEP
Frostiak & Leslie Chartered Accountants Inc.

Business Succession Planning
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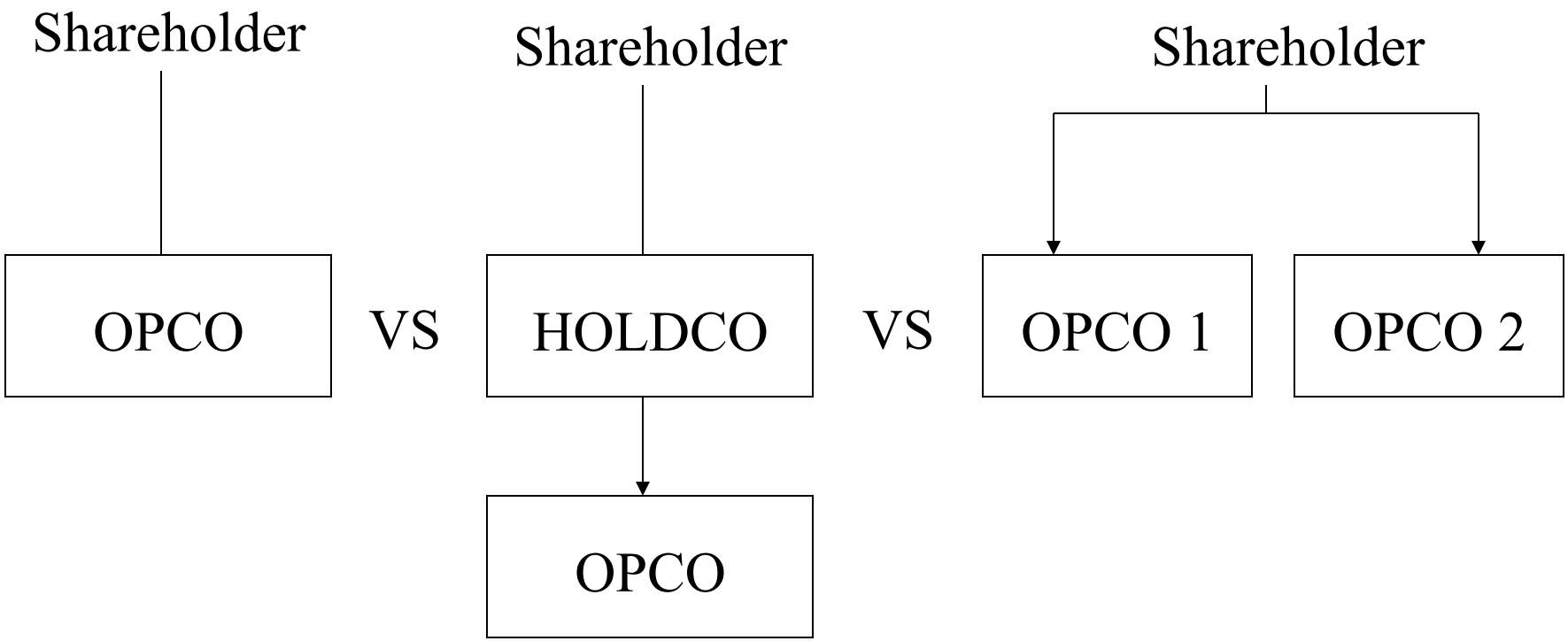
1. Getting the business ready for sale

- Assessing corporate structure
- Removing redundant assets
- Evaluating access to $750K LCGE
- Assessing potential buyers

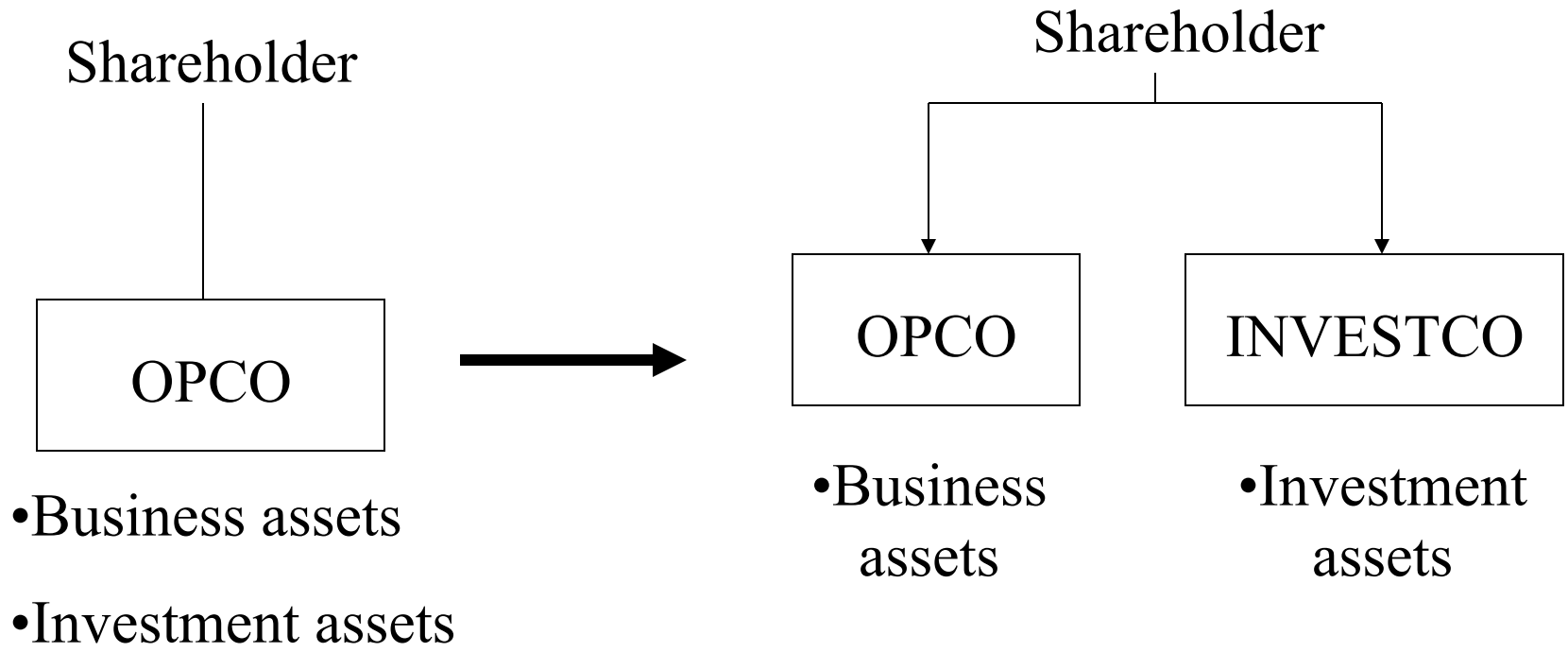
Getting the business ready for sale
1. Assessing the Corporate Structure



Getting the business ready for sale
Assessing the Corporate Structure

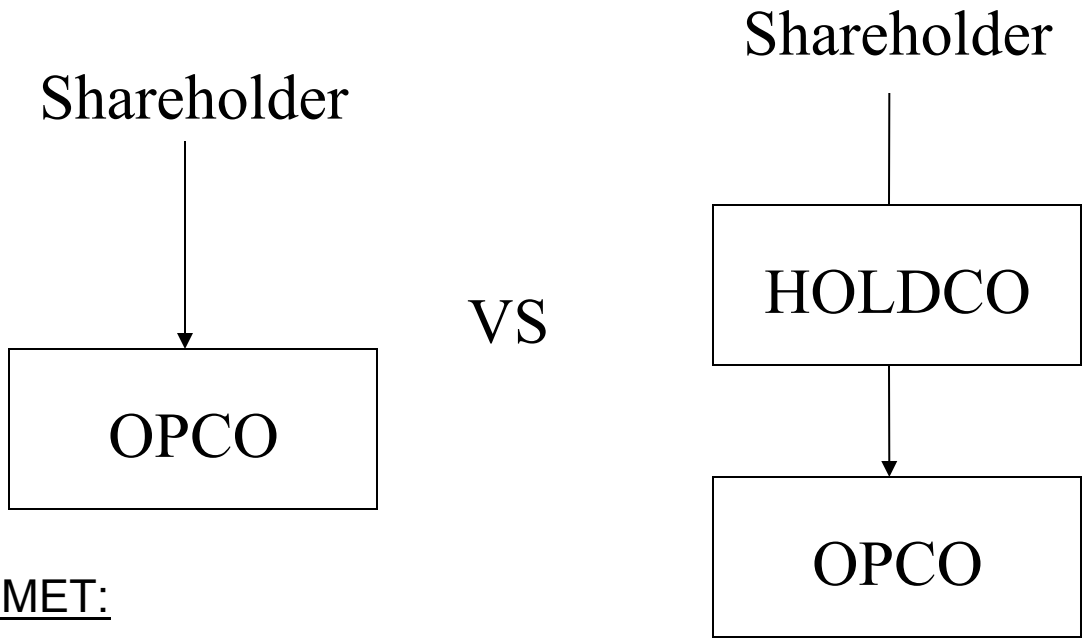
- What is being sold?
- Assets? Corporate tax implications
- Shares? Eligible for $750K LCGE?
- Redundant assets
  - Life insurance policies
  - Real property that could be separated from the business

Getting the business ready for sale
2. Removing Redundant Assets



- "Butterfly out" or "spin-off" redundant assets into a separate corp.
- "Safe income" issues and restrictions where sale to an arm's length purchaser

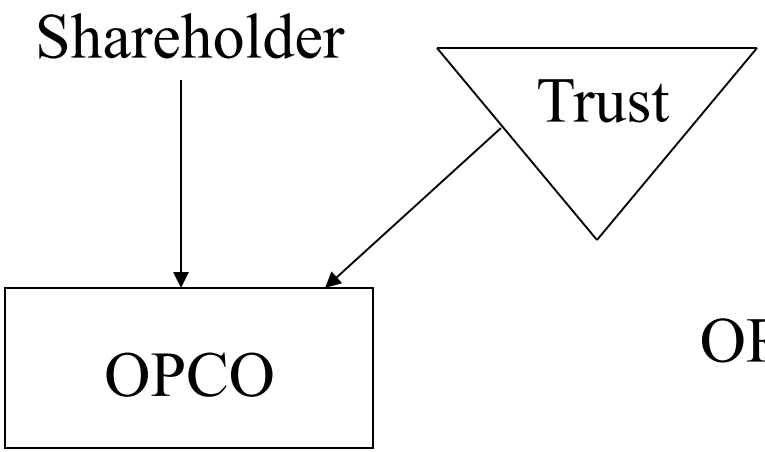
Getting the business ready for sale
3. Evaluating Access to $750K LCGE



TEST TO BE MET:

- 90% or more of assets used in an active business at time of sale
- 50% test for immediately preceding 24 months
- CCPC
- 24 month holding period
- 90% test throughout where there are “connected corps”.

Getting the business ready for sale
Evaluating Access to $750K LCGE



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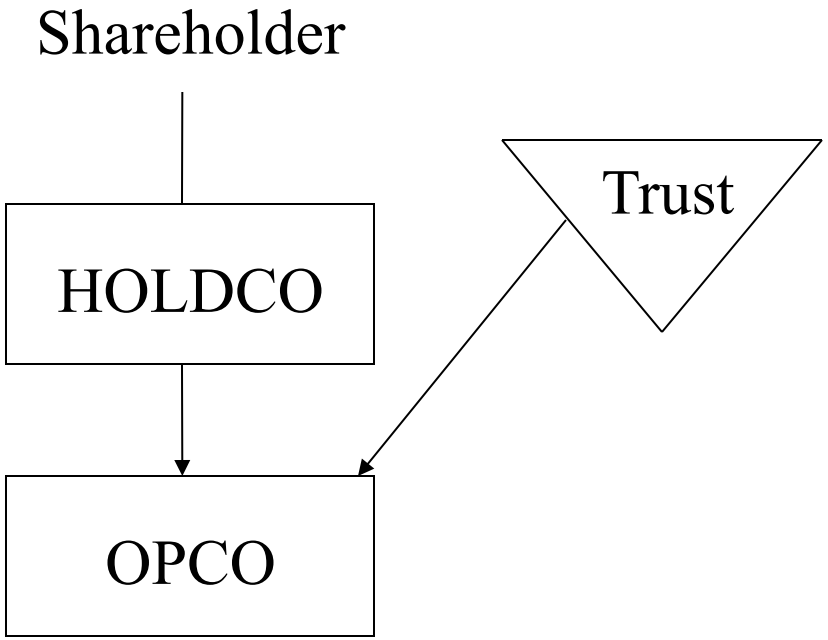


- Multiple access to LCGE
- Capital Gains splitting
- No Attribution for Minors

Getting the business ready for sale
4. Assessing Potential Buyers

Who?

- Heir Inherent (family members)
- Family group managed by outside employees
- Employee group or key employee
- Competition

2. Family Succession Issues

- The "Soft" Issues
- Sale vs. Gift
- Tax Implications

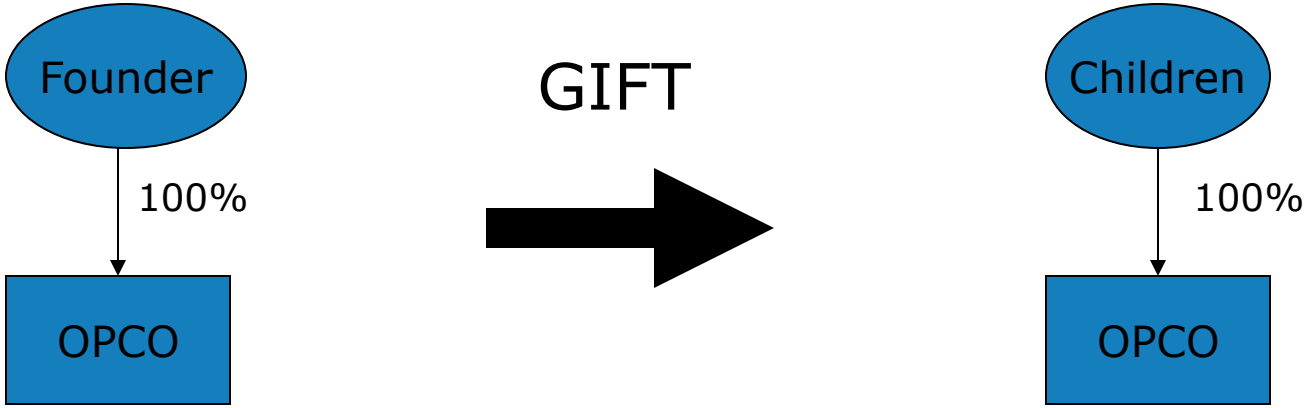
The "Soft" Issues

- Equalization Between Siblings – SIBLING RIVALRY!
- What About "KEY" Employees?
- Are They Ready?
- Ownership vs. Remuneration
- Claims by Family / Creditors

Sale vs. Gift

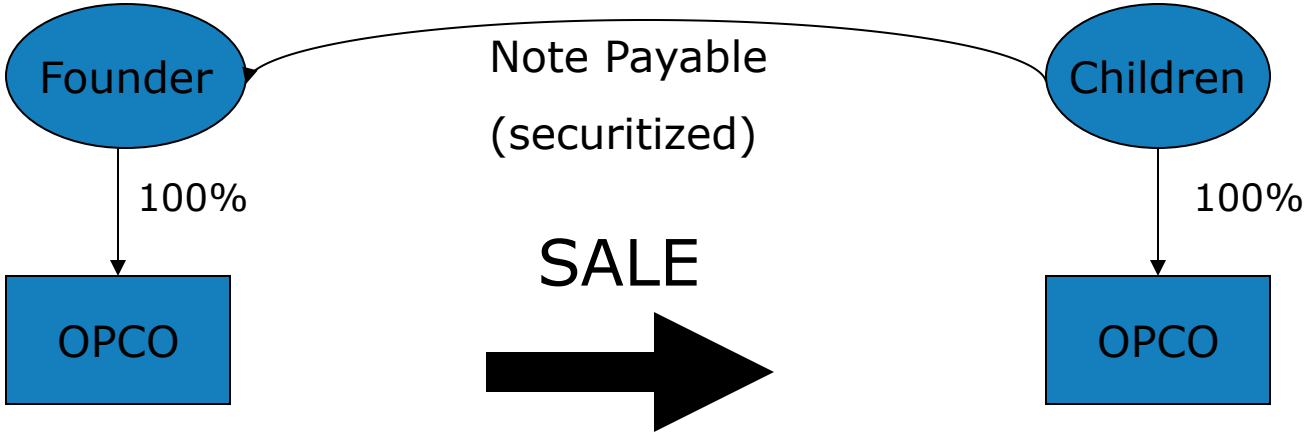
- Cash Needs of Founder?
- Loss of Control?
- Deemed Disposition
- Financing

Sale vs. Gift - Example



- Implications:
  - No cash received on gift
  - Loss of control
  - Gift occurs at FMV / deemed capital gain
  - GAIN Taxable in year of Gift
- Conclusion: generally not recommended

Sale vs. Gift - Example



- Implications:
  - Cash funding back to founder
  - Control exercised over security taken back
  - Sale occurs at FMV / deemed capital gain
  - Gain can be spread out over 5 years

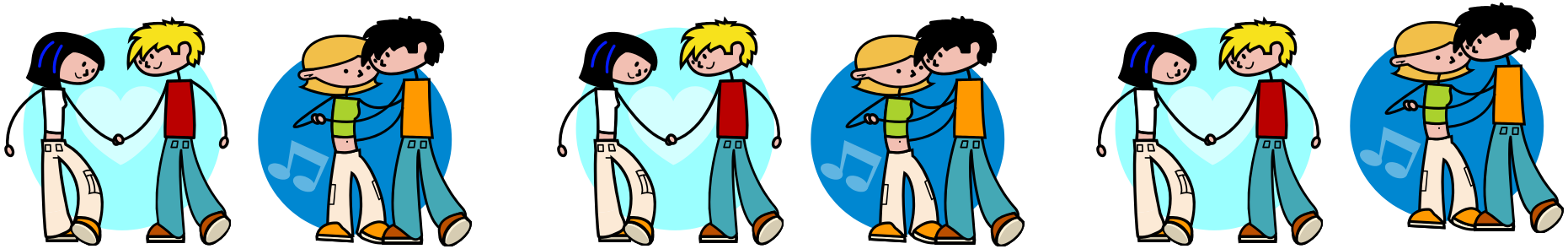
Sale of Shares to Children

Pros

- Founder gets cash
- Degree of control retained
- Possible use of $750K LCGE

Cons

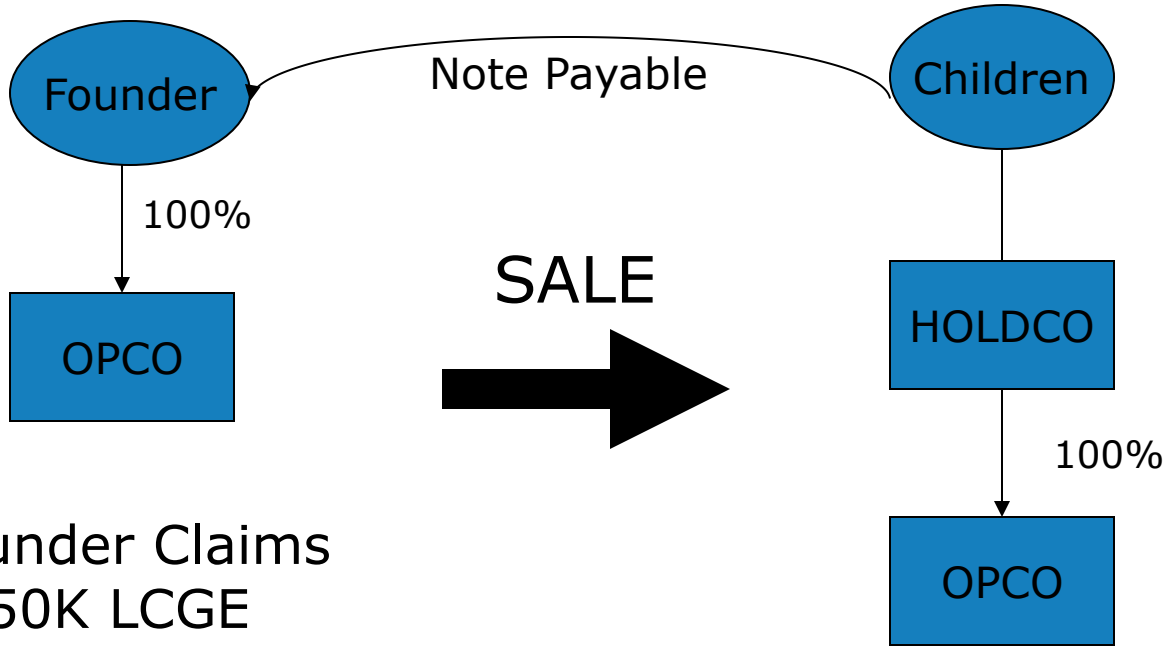
- Financing issues for children
- Tax payable by vendor "front-ended"



Tax Implications

- Disposition occurs whether sale or gift
- Use of $750K LCGE will restrict financing by children
- By wary of Sec 84.1 surplus-stripping rules

Sale of Shares



CORPORATELY FINANCE ACQUISITION?

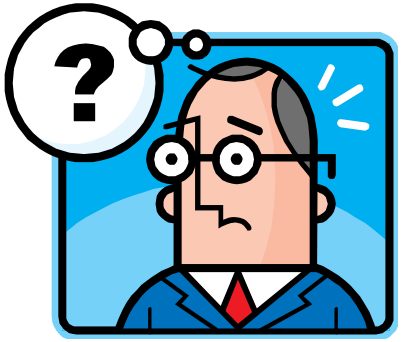
Founder Claims $750K LCGE

Sale of Shares and Sec 84.1

- Proceeds to Founder deemed to be a taxable dividend
- Non-arm' as length sale creates special restrictions on use of LCGE

Succession Planning

So… What can be done?



The Estate Freeze

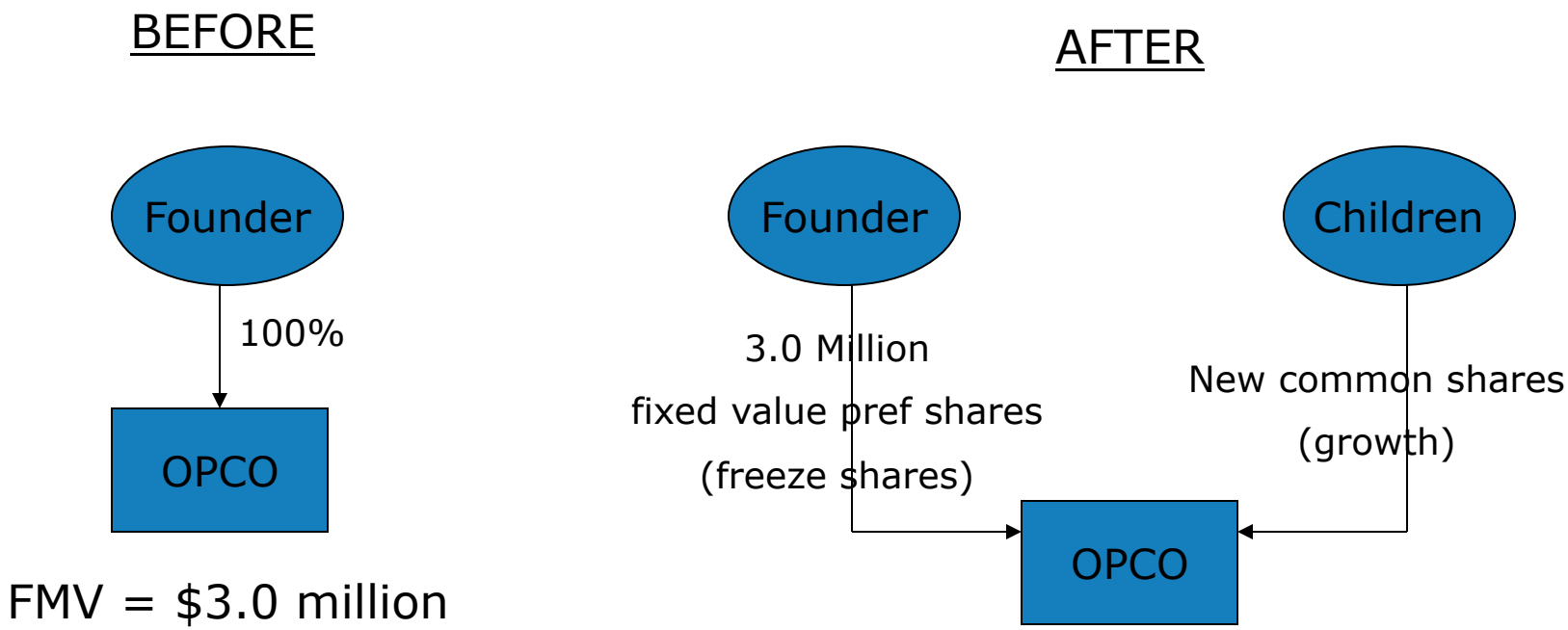
What is an "estate freeze"?

- Exchange common "growth" shares for
  - Fixed Value Preference shares
  - FMV equal to FMV of 'old' common
  - Redeemable
  - Retractable at option of holder
  - VOTING (control)

The Estate Freeze

- Company files "Articles of Reorganization"
- Election under Sec 86(1) of the ITA
- Tax deferred treatment
- Permits successors to subscribe for new common shares (nominal value)

Example 1 – Estate Freeze



Estate Freeze

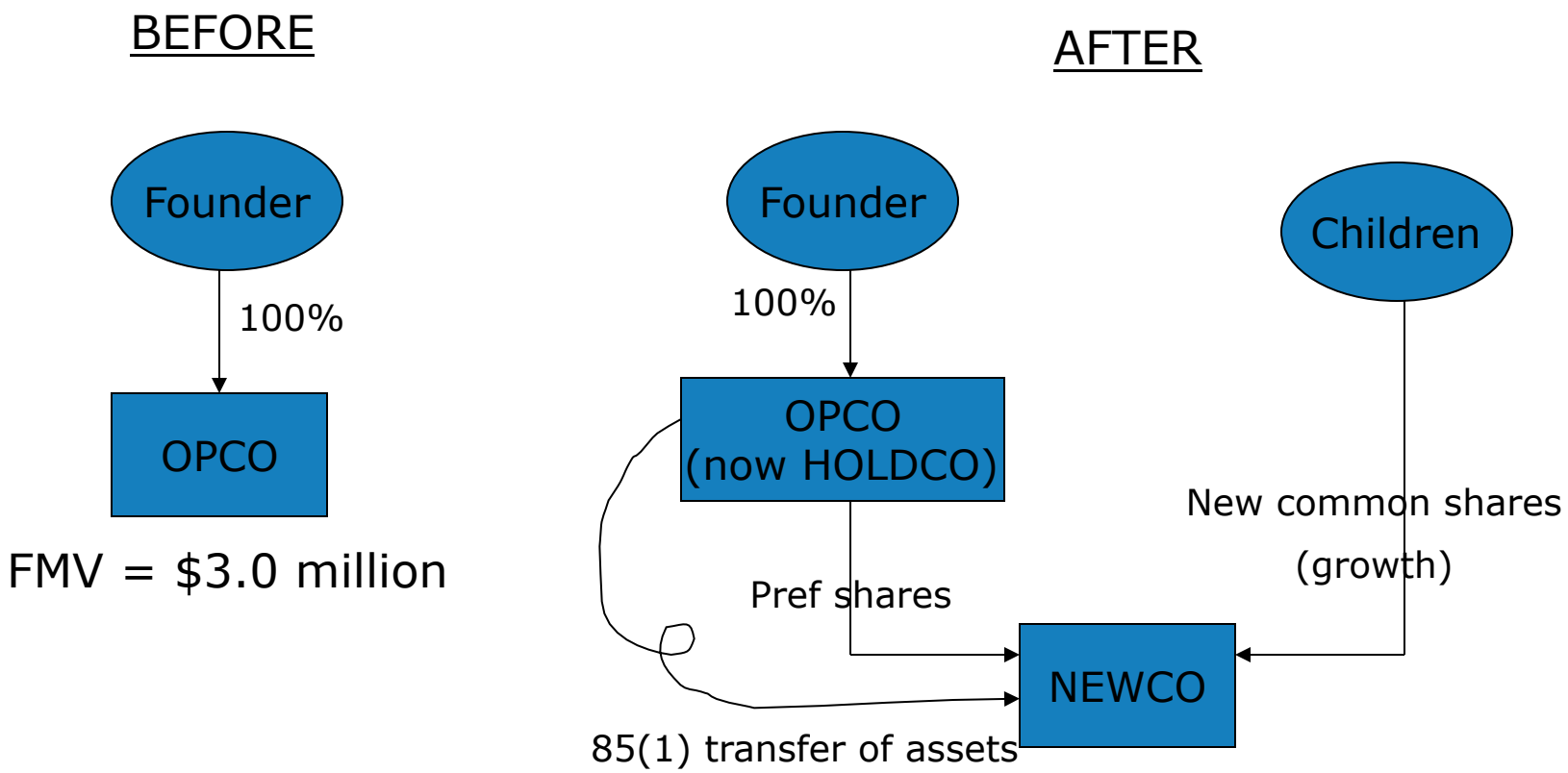
Pros

- Control retained by founder
- Children acquire future growth
- Buyout funded with future earnings / profits
- No immediate tax on transfer

Cons

- No immediate cash payable to founder
- As shares redeemed – tax on deemed dividend

Example 2 – "Downstream" Estate Freeze



Downstream Estate Freeze

Pros

- Control retained by founder
- Can move specific assets to NEWCO
- Creditor proofing at NEW HOLDCO level
- Tax deferred share redemptions

Cons

- No immediate cash payable to founder

3. Business Valuation

1. A business valuation exercise will assist in business strategic planning by highlighting key business value drivers;
2. Business valuation provides key input to:
   - Personal financial planning i.e. an estimate of the value of equity in the family business;
   - Tax planning; and
   - Insurance planning;

Valuation Definitions

1. **Fair market value ("FMV"):**

   This term is commonly used in notional valuations and usually applies to the equity of a business. A common definition of FMV 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 arms length and under no compulsion to transact".

2. **Enterprise Value ("EV"):**

   This term is often used in sale of business transactions. EV refers to the value of the business as supported by all sources of financing, including debt financing. EV is therefore equal to FMV of equity and debt i.e.:

   EV = FMV of equity **plus** debt.

Business Valuation Essentials

Value is driven by:

- Level of sustainable cash flow;
- Level of business risk usually expressed in terms of required capitalization rate or multiple.
- Basic valuation models:

$$\frac{\text{Cash Flow}}{\text{Capitalization Rate} - \text{growth}} = \text{Value}$$

or

Cash Flow X Capitalization Multiple = Value

Business Valuation – General Capitalization Multiples

- Normalized* EBITDA** Multiple Ranges:
- Manufacturing - 4 to 5 times;
- Distribution (wholesale) - 3 to 4 times;
- Services & contracting - 1 to 2 times.
- * Reported earnings plus/minus non-economic and non-recurring items.
- ** EBITDA = Earnings before interest, taxes, depreciation and amortization.

General factors that influence choice of multiple:

- Volatility of earnings;
- Exclusivity (technology, licenses, contracts, etc.)
- Diversification of customer and supplier bases;
- Competitive landscape;
- Underlying collateral (TAB);
- General economic conditions, including credit climate.

4. Asset vs Share Sale

1. Assets

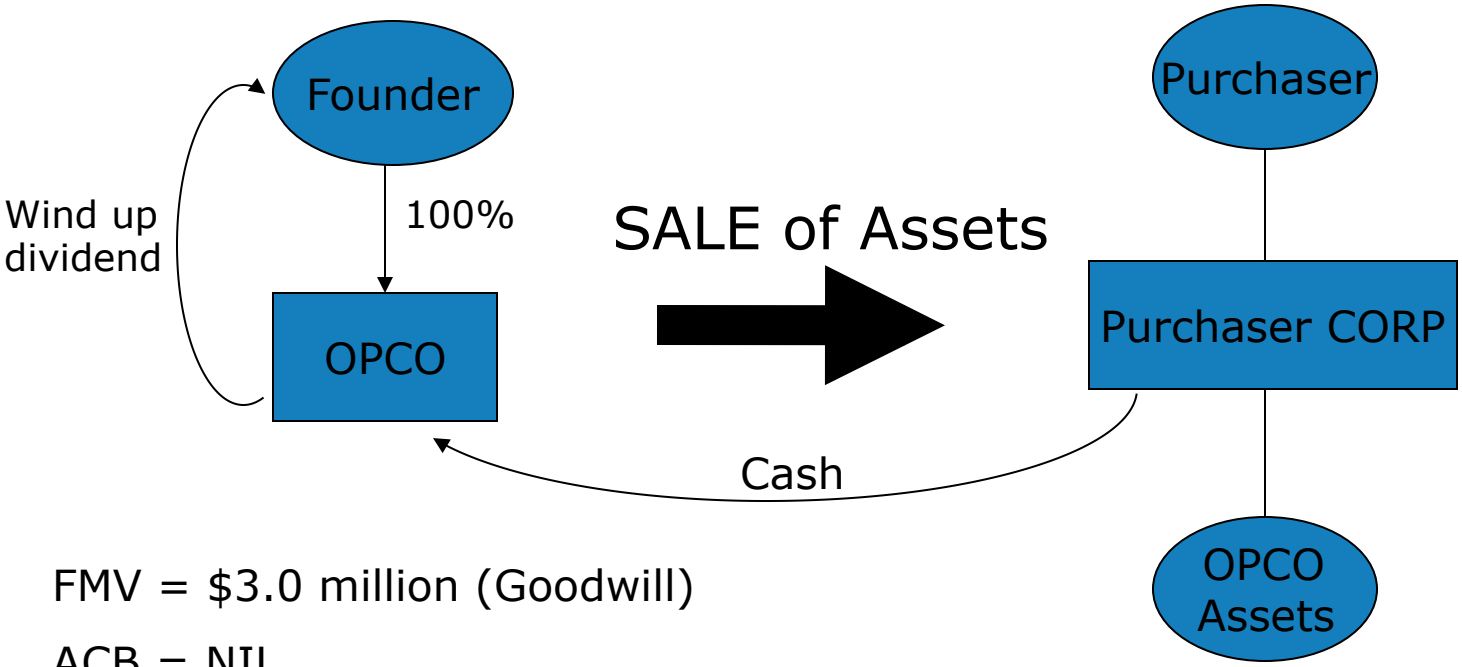
PRO's

- Simple/more straight forward to value assets
- Less liability issues for purchaser
- Stepped up tax cost to purchaser

CON's

- More tax inherent on sale of assets and distribution to shareholders

Example – Sale of Assets



FMV = $3.0 million (Goodwill)

ACB = NIL

Example – Sale of Assets

	($000's)
Proceeds to OPCO	$ 3,000
Corporate tax thereon (approx)	(465)
	2,535
Dividend to Founder	(2,535)
	NIL
Dividend to Founder	2,535
Tax Thereon	(248)
NET CASH Retained	$ 2,287

Sale of Assets

- Corporately taxed / No LCGE
- Second level of tax to remove surplus
- Potential GST / PST implications
- Use of RCA's, IPP's, bonuses etc. to defer or reduce tax

Asset vs. Share Sale

2. Shares

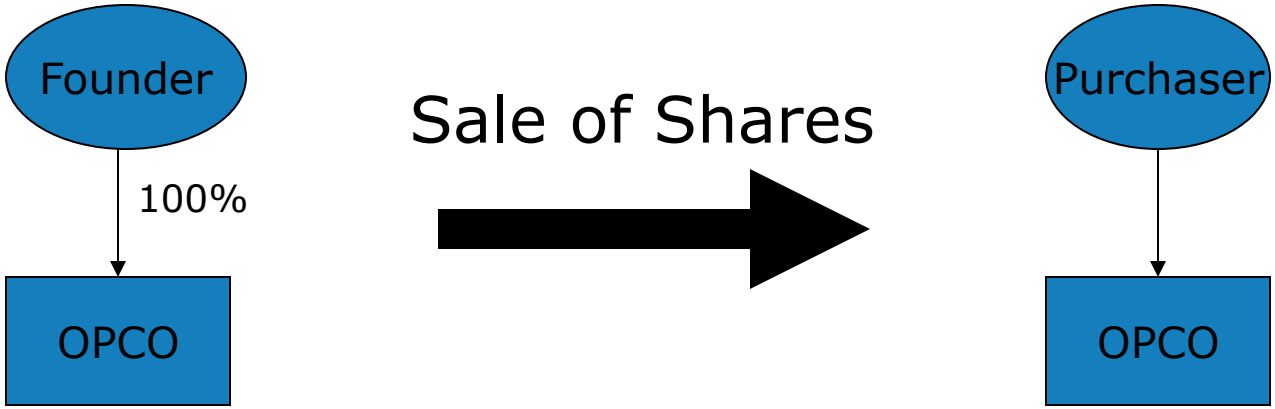
PRO's

- More tax efficient proceeds to vendor
- Potential to access $500K CGE
- Capital Gains splitting with family members

CON's

- Agreement generally more complex
- Could be holdbacks on proceeds/indemnifications given to purchaser
- Deemed year end / tax filing on sale

Example – Sale of Shares



FMV = $3.0 million (Goodwill)

ACB = NIL

Example – Sale of Shares

	($000's)
Proceeds to Founder	$ 3,000
ACB	-
Capital Gain	3,000
Capital Gain Exemption	(750)
Taxable Capital Gain	$ 2,250
Tax Thereon	$ 518
NET CASH Retained	$ 2,482

Sale of Shares

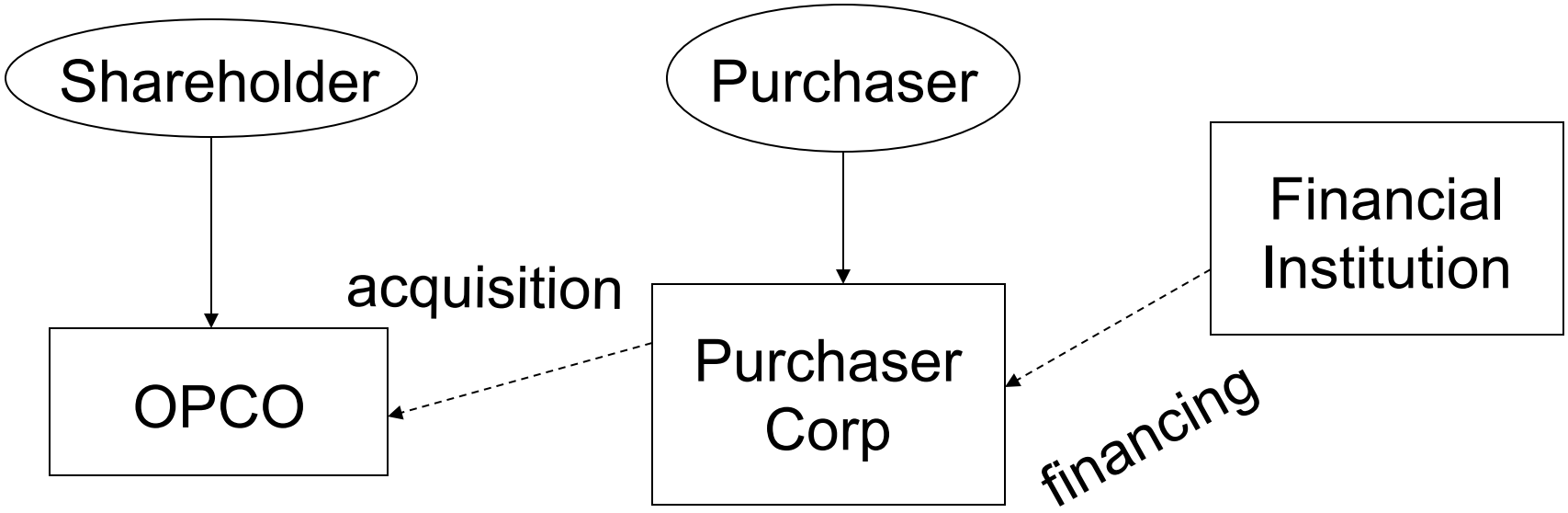
- Keep OPCO onside as a SBC
- Use of $750 LCGE
- Multiply through use of family trust

5. Financing

- Outside Financing
- Vendor Take Back
- LBO
  (Leveraged Buy-Out)

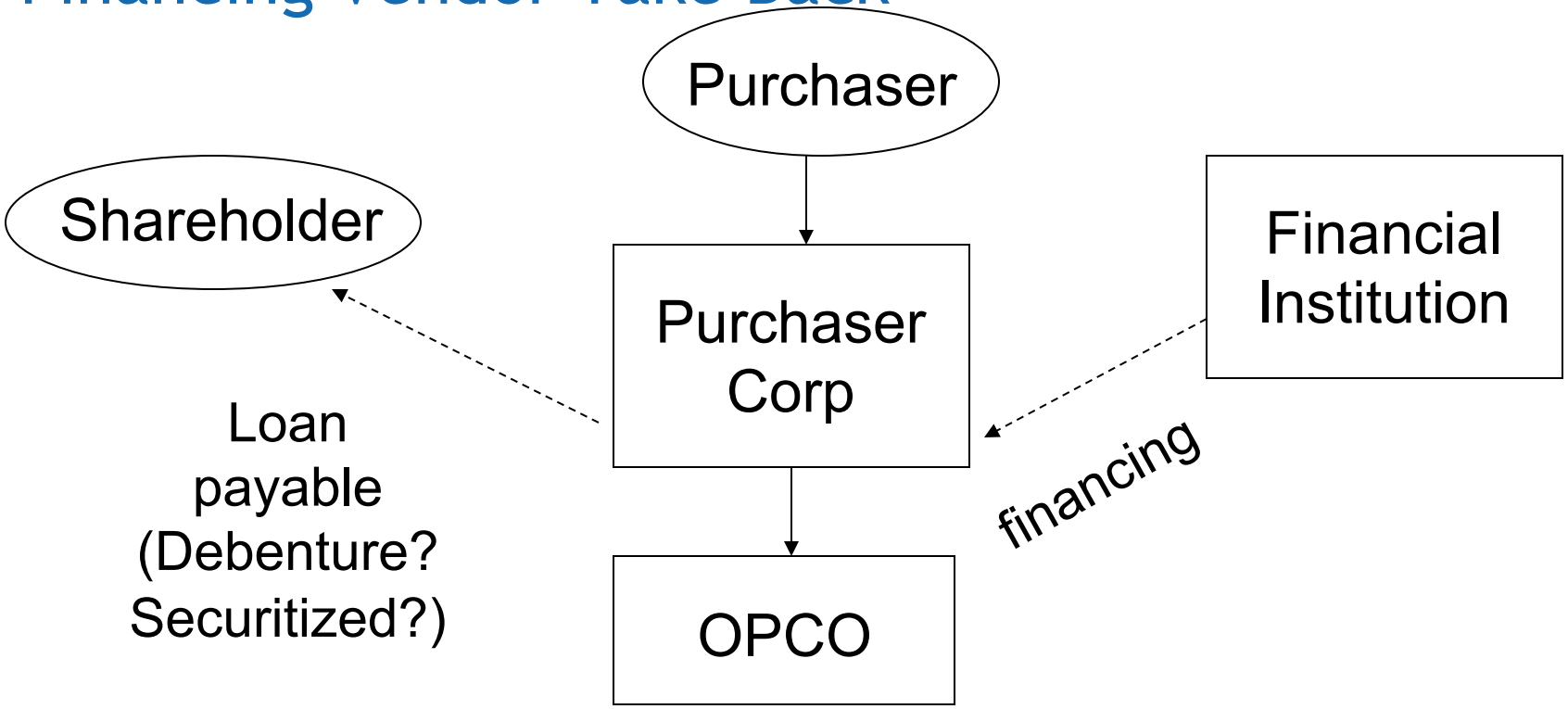
Financing

OUTSIDE FINANCING



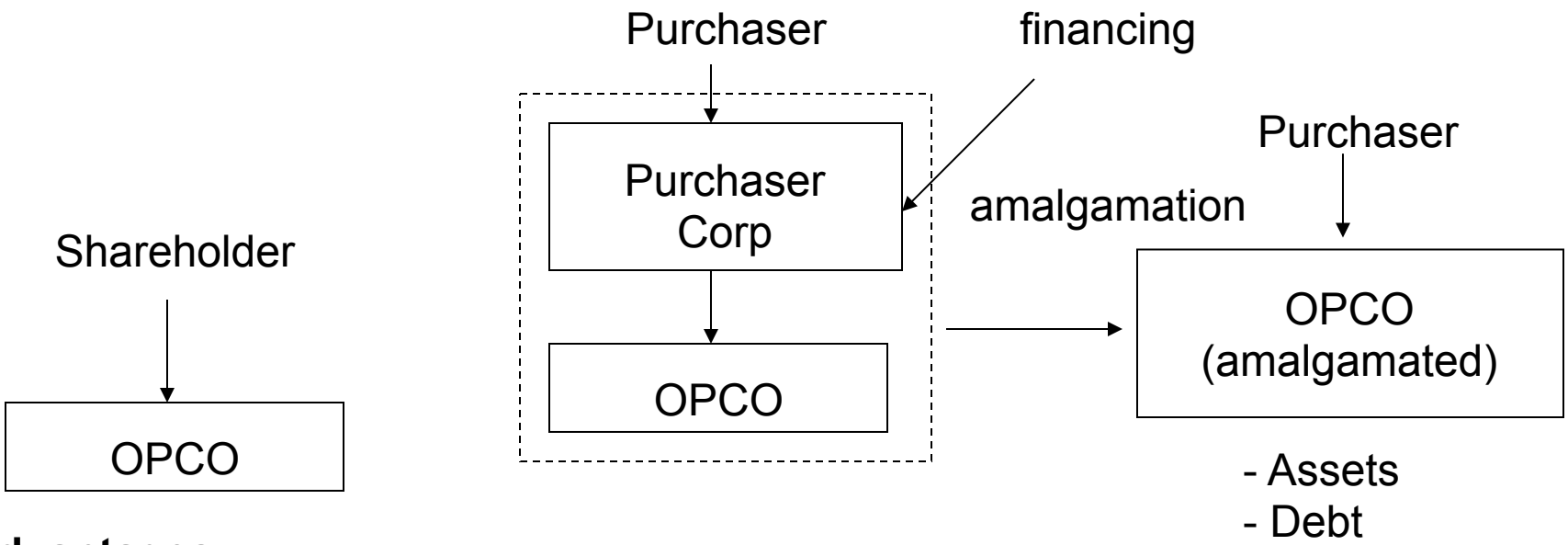
- Fully Financed
- Cash payout to vendor
- Issues on security, debt service, cross guarantees

Financing Vendor Take Back



- Financed in part by vendor (shareholder)
- Issues on security given to vendor, in relationship to security/collateral given to financial institution

Financing Leveraged Buy Out (LBO)



Advantages

- Securitize debt to financial institution with assets with OPCO
- Use assets to leverage debt capability
- Match debt service costs against operations

Disadvantage

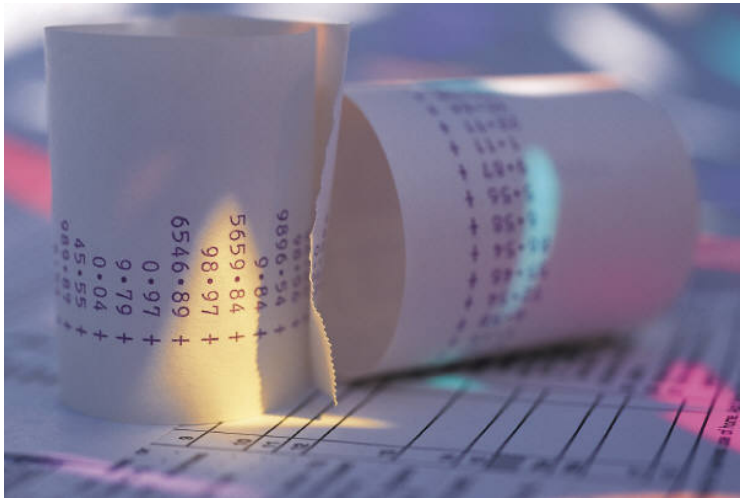
- Loss of ACB on shares of OPCO
- No step up in tax cost of assets within AMALCO

6. Tax Considerations

1. **Use of LCGE**
   - Potential tax savings approx $172K per person
   - On a family of four – potential tax savings of $688 K (capital gains splitting)
   - Plan early to create the "Capital Growth Split"

2. Non-Compete Agreements

- Tax treatment could be problematic for vendor. (Treated as ordinary income)
- Election can be made jointly by vendor and purchaser to treat as proceeds of disposition of share



Tax Considerations Timing of Sale

- Defer proceeds to subsequent calendar year or taxation year
- Date of sale can also affect associated corporations within group for purposes of SBD limit

Tax Considerations Deemed Year End

- Taxation year deemed to occur immediately at time control of corporation acquired
- Generally vendor has responsibility to file and pay taxes
- TIMING CRITICAL – could result in “doubling” up income within same year and loss of SBD

7. Case Study – George & Lynn

- Owned their trucking company over 30 years
- George started out doing “long-hauls” for one of the big Nationals
- Met Lynn at one of his favorite truck stops
- Two kids / neither interested in the business

Case Study – George & Lynn

- Company owns:
  - Warehouse and distribution building
  - Trucks, equipment
  - Trucking rights – key routes in Western Canada

Case Study – George & Lynn

- Retirement a few years away
- Wants to maximize after-tax wealth
- Ensure a good stream of retirement income (historically paid large bonuses to themselves from company profits)

Case Study – George & Lynn

- Issues:
  - How to prepare the business for sale
  - Sale of assets versus a sale of shares
  - Planning for income continuance

Case Study – George & Lynn

- Preparing business for sale:
  - Normalized earnings report
  - Estimate of share value
  - Tax calculations if assets sold
  - Re-tooling corporate structure / remove building to separate company

Case Study – George & Lynn

- Sale of assets versus sale of shares

Sale of Shares

	Pros	Cons
Share Purchase Agreement	- Preferred by Vendor	- Complicated
Use of $750K LCGE	- Tax free proceeds	- Tax complications
		- Corporation must qualify
		- Redundant assets to remove
Ability to multiply use of $750K LCGE	- Additional tax free proceeds to family	- Risks associated with other family members as shareholders
		- Improper valuation on estate freeze
Ongoing Compliance	- Reporting in year of sale; otherwise terminates	- N/A

Case Study – George & Lynn

- Sale of assets versus sale of shares

  Sale of Assets

	Pros	Cons
Asset Purchase Agreement	- Straight forward; easy to structure - Preferred by purchaser (step up in ACB of assets)	- Potential ongoing liabilities to vendor - Exposure to creditors, employee termination issues
Taxation	- Ability to access tax-free CDA if sale properly structured	- Potential for double taxation
Ongoing Compliance	- N/A	- Reporting continues until company dissolved

Case Study – George & Lynn

- Planning for income continuance
  - RRSP
  - IPP
  - RCA
  - Generating tax-efficient investment income (rental income / buildings)
  - Retiring allowance on sale
  - Health Care and Employee Benefit Plan
  - Pension Income Splitting

8. Top Ten Tips

1. Start planning early
2. Assess Family capabilities / readiness
3. Balance cash needs with succession goals
4. Make the business financable (financial reporting)
5. Transition family ownership over time
6. Separate business / investment assets
7. Monitor SBC / QSBCS Status
8. Multiply $750K LCGE with a trust
9. Sell shares if possible
10. Start planning early

9. QUESTIONS?

LARRY FROSTIAK, FCA, CFP, TEP

DIRECT LINE: 487-5200

EMAIL: lfrostiak@cafinancialgroup.com

THANK-YOU!