

Common Exit Strategies

Four of the more common exit strategies for business owners:

Passing the Business to Family

For this exit strategy to work it requires as much advance planning as possible. There are many reasons for this, including the possibility of conflicts and tensions between siblings, spouses, non-family executives, and other investors.

If you decide to pass the business to family, you will need to address:

- **Strategic issues** such as leadership and management choices, restructuring of the business, or sale of all or a portion of the business.
- **Legal & tax issues** such as shareholder agreements, prenuptial agreements, marriage or divorce of a child or shareholder, or death of spouses, key employees or a potential successor.
- **Family policy issues** such as share ownership of family vs. non-family executives, shares for new children or grandchildren, impact of illness or disability, the owner's retirement plans, and employment conditions of family members in the business.

Perhaps the most important question is whether a family succession is even feasible. An owner must be objective in assessing the talents and interests of potential family successors. Questions to ask include:

- Would a family successor be able to secure your investment and retirement income?
- Does a potential family successor have the aptitude, intelligence or skills needed to lead the business forward?
- How would employees, suppliers and customers react?
- What would objective outside professionals or directors advise?
- Can family raise the money for the purchase price?
- Can you divide the value of your business fairly among several family members?
- What is the most tax-efficient way to transfer ownership?
- Do you want to retain control for some period?

To sort out these issues, you may want to try forming a family council. These are regular meetings designed to create trust and understanding around estate planning, retirement and wealth management issues.

The family council is also an excellent vehicle for:

- agreeing on a formal, written policy for family participation in the business;
- developing a formal, structured performance evaluation process for family members; and
- deciding who will have a stake in the business among in-laws, spouses and wider family members.

With a forum for discussion and a basis for assessment, you can deal more effectively with legal, tax and operational issues.

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Selling to Partner or Employees

Your business partners - even minority owners or silent partners-may want to buy you out. One or more key employees may also be interested. Questions to ask include:

- Which employees or business partner(s) should buy your interests?
- Can he or she raise the money to completely buy you out or will you have to finance part of the purchase price?
- If you have to finance the purchase price, can the purchaser run the business well enough that your payments will be secure?
- Who is to be part of the employee-owner group?
- Do employees have the skill and financial resources to complete a purchase?
- Will the purchase be through future profits or employee capital?
- Are employees able to provide personal indemnities and assume successor obligations?

For some owners, selling the business to all employees through an Employee Share Ownership Plan may be the best option. Permitted in many provinces, the ESOP lets an owner sell a majority or minority interest in the form of independently valued shares while maintaining control of the company.

If there's no one aboard who can buy out your interests, plan in advance to bring in a new investor to eventually buy your interests.

Selling to a Third Party

If you have no family, partners or employees ready or interested in taking over the operations, a third-party buyer may be the answer. Some questions to ask include:

- Where can you find an interested buyer?
- Do you want to sell the whole business or parts of it?
- Does the buyer have the money to pay what the business is worth?
- If not, can they run the business well enough to make payments on a portion of the purchase price that you finance?
- What is the most tax-efficient way to structure the sale?

An interested buyer can come from anywhere: your customers, suppliers, even your competitors. There are generally two types of buyers.

Financial buyers: Individuals or companies with money to invest. Some are former corporate executives or angel investors looking for a new project and others are in the business of generating good returns on investments.

Strategic buyers: A competitor, a larger business or a company in a remotely related business. Synergy is an important word to these buyers. Experts suggest they are often the ones who will pay the most for your business if the fit is good.

Apart from finding buyers, another challenge is getting a good price on the open market. Not everyone will offer the money you need to retire on. Your advisor team can help you decide if a third-party sale is the best idea.

Experts also suggest it's often not wise to "test" the open market unless you truly intend to sell. Not only does it make your intentions public, it also drains valuable management time and resources.

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Winding Down the Business

Even if no one wants your business, all is not lost. You can try to sell again, or simply liquidate business assets such as real estate, equipment, proprietary technology, customer lists, finished goods, raw materials, inventory, and accounts receivable.

If your business is incorporated, you will likely need professional advice to "wind-up" the operations. For example, find out the best way to dispose of assets for which you have claimed depreciation. A team of legal, tax and financial experts can help you keep as much as possible in your pocket.

What's Your Business Worth?

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Whichever exit strategy you choose, a crucial factor is the business valuation. You'll need to establish an accurate value for the business so you receive a fair price.

You should engage a professional valuator to help you calculate the net worth of your business. Key questions to address include:

- What do you have to sell (for example, customer lists, contracts, inventory, equipment, etc.)?
- Is your business more valuable in pieces or as a whole?
- How can you determine a fair market value?
- What can you do to improve the value of your business between now and retirement?
- How much of the value and long-term future in your business is tied to you being at the helm?
- Is the business actually building any equity?

Professional Valuation Methods

If your business is complex or has significant assets, a professional valuator can use a variety of methods to come up with a fair value, including:

Cost or asset-based approach: Simply, this totals all the business expenditures and investments to date.

Market value approach: Comparable businesses are examined and other similar transactions can help establish a value.

Earnings approach: This most common approach estimates a price based on historical or future earnings. A discounted cash-flow approach is usually applied to the future income stream.

Strategies to Raise Value

What if the value is lower than you expected? With advance planning, you may be able to raise the value before selling.

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Increase income: Your accountant can suggest ways to improve your financials and bottom line, which may include spending more on marketing and sales, and cutting administrative costs.

Improve assets: You may be able to dispose of unproductive assets or buy certain assets (such as your company car) to get them off the balance sheet.

Reduce liabilities: Settle any pending lawsuits, unpaid taxes, warranty claims, etc.

Tackling Legal and Tax Issues

Tax issues are perhaps the biggest single factor in estate planning. The goal is to legally minimize the tax burden for the deceased owner's estate, spouse, family and business itself.

Perhaps the most challenging aspect of retirement planning for business owners is getting through the maze of legal, tax and financial issues.

Here are some of the major issues you'll need to discuss with a team of professional advisors.

Death & Taxes: Life's Certainties

Tax issues are perhaps the biggest single factor in estate planning. The goal is to legally minimize the tax burden for the deceased owner's estate, spouse, family and business itself.

Under Canadian tax law, an individual who sells shares in a "Qualified Small Business Corporation" (QSBC) has a lifetime exemption from the tax on up to \$500,000 of capital gains. Taking advantage of this exemption means meeting several conditions that only a tax professional can properly assess.

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Estate freeze

The most common method for triggering the exemption is an estate freeze. The objective is to crystallize the current fair-market value of the owner's business at a moment in time, usually by:

- Exchanging your old common shares for new preferred fixed-price voting shares; and
- Issuing new common limited-voting shares to other family members with all future growth attached

An estate freeze is just one of many tax strategies and may not be best for all businesses. Consult a tax professional.

Probate Fees

Each province sets its own probate fees-usually a sliding percentage of the estate's value. Probate is a judicial process that confirms the authority of an executor. To protect themselves from legal liability, third parties such as financial institutions usually require probate before they transfer assets to the executor.

Owners and their families can plan to minimize probate fees, primarily by minimizing the amount of the estate that is subject to the probate process. This can be accomplished various ways, such as transferring assets before death, using spousal trusts, and other options that are beyond the scope of this Guide.

A lawyer or estate planner can discuss options that apply specifically to you.

Dividends or Capital Gains?

Federal reductions to the tax rate for capital gains have many tax advisors suggesting that business owners revisit their retirement plans.

At higher marginal tax rates, capital gains treatment can have a lower tax rate than deemed dividends. You may benefit from having your will and shareholders agreement reviewed.

A professional tax advisor can tell you more.

Income Splitting with Children

Canadian tax law requires a related minor who receives certain income, usually dividends, to incur a special tax liability. He or she is taxed, at the top marginal rate, on the following types of income from the following sources:

- taxable dividends and other shareholder benefits from private shares of related Canadian and foreign companies (directly or through a trust or partnership); and
- income originating from a related business (as above) that is channeled through a partnership or trust.

These rules do not apply to income received from normal arms-length investments. Consult a professional tax advisor to see how these rules apply to your situation.

Alter Ego & Joint Partner Trusts

The Canadian government recently enacted changes to the tax laws that allow seniors to create an alter ego trust. This type of trust:

- reduces probate taxes by removing assets from your estate;
- allows you increased control over who ultimately receives the assets transferred to the trust (in case your will is disputed); and

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- serves as an efficient alternative to a power of attorney if you are incapacitated.

The terms of the trust must say that only the individual setting up the trust (the "settlor") is entitled to income earned before his/her own death, and must name contingent beneficiaries after death.

Another variation is the joint partner trust. No dispositions are triggered when the property is first transferred to the trust, and the income is taxable in the joint partners' hands during their lifetime.

Got Cross-Border Assets?

Increasingly, business owners have personal or business assets in other countries, such as the United States. A professional advisor will need to factor the special tax consequences into your retirement plan.

Family Laws: Your Unseen Business Partner

Most business owners are aware that marital breakdown can affect the company. In calculating each spouse's net worth, a value for interests in partnerships and shares in corporations is usually included. Lump sum settlements or buy-outs require liquidity, which may not always be there.

Pre-nuptial agreements are often used to protect active businesses. A lawyer can advise you about available options.

Consider a Legal Review

A thorough legal review can identify aspects of your business that could derail a retirement strategy, such as:

- organizational structure;
- board and director positions;
- securities and financing;
- human resources and personnel policies;
- intellectual property;
- risk management; and
- shareholder agreements.

Grooming Your Successor

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Choosing a Successor

Whether your exit plan involves family members, business partners or even employees, a great deal of work must be done to ready the company's leadership for continued success.

Choosing a successor involves three steps:

1. Identifying future leadership needs of the business.
2. Assessing existing skills and potential candidates.

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3. Creating a feedback and monitoring mechanism to assess the progress of leaders-in-training.

What qualifications are needed for your successor? Apart from business skills and knowledge, you might consider candidates with the following leadership qualities:

- global thinking;
- focus on results;
- performs tasks & projects with speed;
- keeps a customer focus;
- has concern for people;
- respects others; and
- trusts others and is trustworthy.

Your retirement plan should include a written job description for the chief leadership position that family and other interested candidates can study.

Creating and Implementing a Retirement Plan

Your business may not need the full range of experts out there, but it is worth involving at least one experienced small business advisor.

Your Exit Strategy Team

The next step is creating your plan to retire from the business. Start by pulling together a strong team of advisors.

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The accountant: Accountants may be able to help you make your business more financially sound and attractive to buyers. Another reason to consider hiring a chartered accountant is to start getting audited financial statements—a valuable feature in the eyes of many buyers. Experts suggest your accountant should also work closely with your legal advisor to ensure there is no duplication of effort.

The lawyer: Look for a legal advisor or law firm that specializes in business and estate law and has actual experience in selling businesses, setting up business trusts, planning taxes and drafting shareholder agreements. Ask for client references, if you feel the need.

The tax advisor: Tax experts can be found in your accounting firm or law firm. Your tax advisor must have a clear understanding of your business, your personal goals and your family needs - encompassing both personal and corporate tax issues.

The appraiser or valuator: There may be a qualified business valuator in your chartered accounting firm or you can find one through the Canadian Institute of Chartered Business Valuators. After studying financial records and learning the

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strengths and weaknesses of your business, the valuator can offer a reasonably accurate estimate of market value.

The banker or lender: A lender experienced with small or medium-sized businesses can offer valuable advice at each step of retirement planning. Your lender may also be of assistance financing the sale or transfer of your business.

The broker: Brokers have a large pool of potential buyers, can sift out poor prospects, and offer selling tips you can't get from your other advisors. Brokers usually get a commission tied to the final selling price that can range as high as 10-15%. Review the sales agreement with your lawyer.

Put It All In Writing

Setting out the key elements and stages of your exit strategy on paper will help give you a clear picture of what needs to be done and when. Common sections in a written plan include:

Long-term business goals: This should outline how the current ownership and others see the business growing in years to come.

Financial statements & issues: These reports provide a snapshot of your business' assets, liabilities and tax exposure.

Owner's retirement needs: Include an assessment of the owner's personal financial situation, showing the amount of investment in the business and income needs in future years.

How to identify, assess and declare a successor: State what types of leadership skills, education levels and other talents the business will need.

Ownership and management structure: Set out the ownership rights and business responsibilities of key family members and employees.

Critical path and timetable: A critical path of events is needed, ranging from the completion dates of educational requirements for potential successors to the transition date.

Communication plan: A communication strategy for other family, shareholders, employees, customers and professional advisors is also important.

Other aspects of the written retirement plan such as legal or tax procedures can be hammered out with professional advisors.

Revising Your Shareholders Agreement

Your shareholders agreement is critical, since it addresses so many core retirement issues:

- division of ownership, power and share structure;
- roles and responsibilities of shareholders;
- composition of the board and voting rights;
- framework for resolving shareholder disputes;
- options in the event of death, disability, divorce and other unforeseen circumstances; and
- buy-sell provisions.

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In some cases, a retirement plan will require a new shareholders agreement.

Buy-Sell Agreements

Buy-sell agreements set out terms and conditions for acquiring and selling interests in the business. These agreements provide liquidity for the estate, and business continuity in the event of the death, disability or retirement of an owner.

A legal advisor and tax accountant should help determine the best form of buy-sell agreement for each business.

Insurance

Insurance is a specialized business tool. For example, under a buy-sell agreement, co-owned businesses can use insurance to finance the purchase of a shareholder's interests in the event of death or incapacity. "Key person insurance" helps compensate a business for any financial losses due to the death or disability of an essential person. Think about disability income replacement insurance for yourself as well.

Lining Up Financing Options

Traditional financing options for retirement include:

- secured loans, based on hard assets;
- subordinated debt, which is used when cash flow is strong; and
- equity investments.

Increasingly, owners are also looking to a wide variety of insurance products to finance retirement and protect against illness. These insurance-based plans should be carefully scrutinized in advance by your advisors.

Revisit Your Plan Regularly

As you near retirement or the exit moment, you should revisit your plan to ensure it's on track. Here are some warning signs that it isn't:

- Rigid, inflexible provisions not tailored to the people involved or changing circumstances
- Lack of opportunity that causes key people to leave anyway
- Poor communication of the plan
- Selection of unqualified or unmotivated people
- Failure to hold individuals accountable for goals and requirements

Why Are You Still Here?

It can be difficult for owners to leave the business they created. They may want to remain involved with the operations beyond the retirement date.

Researchers have found that transition to new ownership and management is most successful when the previous owners pursue other interests-or even start another business.

In the end, perhaps the most important retirement goal you can set for yourself is to take advantage of other opportunities life can offer.

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For More Information

The Canadian Association of Family Enterprise offers annual conferences, publications and local meetings to help family-owned businesses.

Articles and publications on the tax aspects of retiring from your business:

- ▶ Grant Thornton LLP www.grantthornton.ca

- ▶ Dunwoody LLP www.bdo.ca

Several universities offer courses in managing family-owned businesses, and retirement planning:

Acadia University (Wolfville, Nova Scotia)	Acadia Centre for Small Business and Entrepreneurship http://acsbe.acadiu.ca/
Memorial University of Newfoundland	PJ Gardiner Institute for Small Business Studies http://www.busi.mun.ca/pig/
Université de Montreal	Chair of Small and Medium-size Business Development and Succession - École des hautes études commerciales http://www.hec.ca/chairepme/
University of Alberta	Centre for Entrepreneurship and Family Enterprise http://www.bus.ualberta.ca/cefe
University of Waterloo	Centre for Family Business http://www.cffb.ca/main.php