Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Five key questions for business owners

According to the Canadian Federation of Independent Business (CFIB) Business Succession Planning survey,[1] 76% of business owners plan to exit their business in the next 10 years — only 9% have a formal, written succession plan, and 46% have no plan at all. If you're wondering how to start formulating your own plan, remember the acronym "SWORD" and ask yourself these five key questions:

S What is my corporate **s**tructure?
W What is my business **w**orth?
O What are my exit **o**ptions?
R What does my **r**etirement look like?
D What would happen if I **d**ied yesterday?

This article explores these five important concepts and discusses strategies that may help minimize your personal and corporate tax, increase your retirement income, provide an effective succession plan for your business and enhance your estate.

Any reference to a spouse in this article also includes a common-law partner.

1 The CFIB Business Succession Planning survey was conducted online June 27–August 17, 2022, and was based on a sample of 2,479 small business owners from Canada. For comparison purposes, a probability sample with the same number of respondents would have a margin of error of +/-2.0%, 19 times out of 20.

1. What is my corporate structure?

The business structure you choose can influence many aspects of your business, from how much you pay in taxes to how much of your personal assets are at risk. You'll want to choose the structure that best suits your needs, which may change as your business evolves. Although you can operate a business in several ways, the most common structures are a sole proprietorship and a corporation.

Sole proprietorship

If you operate as a sole proprietor, your business is unincorporated. It's the simplest type of business structure. You assume all the risks of the business and you pay personal income tax on the net income generated by your business. You may now be wondering whether you and your businesses could benefit from a corporate structure. Generally, the most compelling reasons to incorporate are the potential to defer income tax and split income with family members. In addition, if you plan to exit your business in the future, incorporating offers another substantial benefit: you may be eligible to claim the lifetime capital gains exemption (LCGE) on the sale of your business.

Tax savings from claiming the LCGE

The LCGE may provide a significant tax break, as it allows you to shield up to a certain amount of capital gains from tax when you dispose of shares in a qualifying small business corporation (QSBC).

As a sole proprietor, you need to transfer all or substantially all of your business assets into a corporation and sell the shares of the newly formed corporation in order to be able to qualify for the LCGE. Therefore, incorporating your business may enable you to sell your shares and shelter any growth in the value of your shares from tax, up to the LCGE limit. For more information, please ask your RBC advisor for the article on the capital gains exemption on the sale of private company shares. Claiming the LCGE on qualified farm and fishing property is beyond the scope of this article; please ask your RBC advisor for other relevant articles.

Corporation

If you're already incorporated, there may still be ways to restructure your corporation's ownership to improve tax efficiency and simplify your estate planning. As the sole owner of an incorporated business that has grown in value and may continue growing, you may consider implementing an estate freeze.

Benefits of an estate freeze

An estate freeze allows you to lock in or "freeze" the value of your shares as of a particular date and transfer the future growth on to your successors (for example, family members or even key employees). A freeze may be beneficial when you expect your corporation to continue growing in value, you've already accumulated sufficient net worth, and you either plan to sell the business in the future and/or there's a clear successor or next generation of owners.

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Considering an estate freeze

To implement an estate freeze, you would exchange property that's likely to grow in value (i.e. the common shares of your business) for property with no growth potential (i.e. fixed-value preferred shares) on a tax-deferred basis. Your family members or a family trust would then typically receive new common shares at a nominal value that would benefit from any future growth in the company's value. You can use the frozen shares' value to fund your retirement, while your family members begin to work in the business and contribute to its future growth.

The potential benefits of implementing an estate freeze include:

- **Establish a determinable future tax liability:** You can lock in the value of your shareholdings and the associated tax liability that will be triggered upon the eventual disposition of your shares.
- **Income splitting opportunities:** Subject to the tax on split income (TOSI) rules, you may split income by having your corporation pay dividends to your family members who are in lower marginal tax brackets, thereby reducing your family's overall tax bill.
- **Multiply the LCGE:** Since each individual shareholder is entitled to claim an LCGE on the disposition of QSBC shares, if your family members own shares of the corporation, either directly or indirectly through a family trust, they can also take advantage of their exemption and reduce the total taxes your family owes on the sale of your business.

If you're considering an estate freeze, keep the following in mind:

- An estate freeze can add complexity to your affairs, especially if you introduce a holding company and/or a family trust into your business structure as part of the estate freeze. You should also be mindful of increased annual legal and accounting fees due to this added complexity.

- If you intend to sell the shares of your corporation shortly after the freeze, or if your family members intend to sell the shares soon after your death, an estate freeze may not be as effective since the ability to defer taxation could be minimal. Be sure to talk to your family members to determine their intentions before implementing an estate freeze.
- If you incorporate a trust in the estate freeze, you should be aware of the 21-year deemed disposition rule. To prevent the indefinite deferral of capital gains accumulated in a trust, the trust is deemed to have disposed of its assets every 21 years for tax purposes. The trust must report all accumulated gains and losses on its tax return as if it actually sold the assets for fair market value. If the trust holds real estate or business assets, you may need to engage business valuators to establish a proper value. If you expect the freeze to be in place for longer than 21 years, consider taking steps to plan for the deemed disposition.

For more information on estate freezes, including examples of how an estate freeze can be structured, please ask your RBC advisor for the article on that topic.

Consider setting up a holding company

An investment holding company isn't a defined term in the Income Tax Act. Instead, it's a term used to describe a corporation that doesn't operate an active business. You typically use it to own shares of a private corporation with an active business and/or hold passive assets, such as publicly traded securities, bonds, real estate and so on.

Some potential benefits of setting up a holding company include:

- **Creditor protection:** If your operating company has excess funds, you may want to move them to a holding company to protect them from creditors of your operating company. If your operating company needs working capital, your holding company can lend the money back to your operating company on a secured basis to maintain the potential protection from creditors. When considering creditor protection, you should speak with a qualified legal advisor about the options available to you.
- **Purifying your corporation:** If you own shares of a QSBC, you may be able to save a significant amount of tax by claiming the LCGE on a future sale of those shares. To keep your operating company onside with QSBC requirements, you may need to remove surplus funds not required for active operations, or "purify" your corporation, on a regular basis to ensure you can claim the LCGE. You can generally remove the excess funds from your operating company by transferring them to an investment holding company on a tax-deferred basis. However, the process of doing so can be complex and it's important to work with a qualified tax advisor to ensure you can complete the transfer on a tax-deferred basis while maintaining the ability to claim the LCGE.
- **Controlling the amount and timing of income:** A holding company may also provide flexibility if you own an operating company, along with other shareholders, that pays out dividends each year. If you don't want to receive the dividends personally, it may be possible to have the dividends paid to your holding company on a tax-deferred basis. You can withdraw funds from your holding company when you need the funds.

Your business may represent the most significant part of your personal net worth. Like many other business owners, you may be relying on the proceeds from a future sale to fund your retirement or other financial goals. Knowing the value of your business is essential to the sale, as well as any tax, contingency, retirement or estate planning.

It's important to determine the goals and objectives you want to achieve, so you can decide the best way to introduce a holding company. You'll also need to consider the costs and complexity of introducing a holding company in your business structure. For more information about holding companies, ask your RBC advisor for an article on that topic.

2. What is my business worth?

Your business may represent the most significant part of your personal net worth. Like many other business owners, you may be relying on the proceeds from a future sale to fund your retirement or other financial goals. Knowing the value of your business is essential to the sale, as well as any tax, contingency, retirement or estate planning.

For example, a business valuation is critical when implementing certain tax planning strategies, such as an estate freeze. In this case, you need an accurate valuation to determine the fair market value of the common shares you're exchanging. As such, when completing an estate freeze, many business owners will hire a qualified business valuator to prepare a business valuation report opining on the fair market value of the company's shares.

Factors affecting company value

You'll want to understand the various factors that affect your company's value. Doing so can help you continue to build on strengths, work on weaknesses, take advantage of opportunities and mitigate risks so you can continue to grow your business.

Here are some factors that influence the value of your company:

- Consistent, recurring, growing cash flow
- Certainty of cash flow
- Favourable industry dynamics
- Strong management team
- Growing diversified customer base
- Sustainable competitive advantage
- Price-sensitive commodity product/proprietary offering
- Barriers to entry
- Public/private/scale

3. What are my exit options?

When exiting your business, you may be contemplating a sell to internal buyers, such as management or family, or to external buyers, such as a larger company in your industry or to a private equity firm.

External buyers

If your priority is to exit completely and realize immediate liquidity from the sale, an external buyer is likely the preferred choice. An external sale can also provide an opportunity to secure the highest price for your business, leaving with you with more cash upfront. This is because larger companies or private equity firms generally have greater access to capital and more financial resources.

A business broker that specializes in your line of business can facilitate buyer outreach and help you find the right buyer. In addition, a business broker can initiate a market check, as part of the sale process, to determine whether a proposed price is fair.

If you'd like to speak to an RBC specialist about finding a buyer for your business, your RBC advisor can refer you to the RBC Mid-Market Mergers & Acquisitions group to discuss its services.

An interested external buyer may require substantial disclosure of financial information and perform a significant amount of due diligence. Since the buyer may request access to sensitive information you may not necessarily want to provide, it's recommended to have a qualified legal advisor involved in the process. They can help determine which information you can and should provide to the potential buyer as part of the due diligence process, as well as to assist with negotiating and structuring the sale of your business.

Internal buyers

Complex family dynamics or personal dynamics with employees can create challenges for internal sales.

A business broker that specializes in your line of business can facilitate buyer outreach and help you find the right buyer. In addition, a business broker can initiate a market check, as part of the sale process, to determine whether a proposed price is fair.

Many struggle to identify suitable successors with the necessary business acumen, often leading to conflicts or a lack of direction when the current owners step down.

Another common reason business owners don't sell internally to family or to management is the lack of adequate financial resources available to the buyer. Generally, in a sale to an internal party, you'd receive less cash upfront and you'd receive the remaining proceeds over time through a vendor take-back (VTB) note. Your future sale proceeds would be dependent on the success of the business being run by family or management, leaving you holding risk moving forward.

That said, selling to your family or management team may also offer distinct advantages. The sale process is usually confidential, with the buyer needing to do limited due diligence. You have an established relationship with the buyer who's likely familiar with the business, leading to a smoother transition. Additionally, when selling internally, you may be able to remain involved with the business, even after the sale, which would allow for a gradual transition, provide flexibility and reduce some of the uncertainty inherent to the process.

Selling to your family can also provide a way to build wealth across generations, where you can structure the sale to minimize taxes. For example, you could structure the sale so you receive proceeds over a number of years. Doing so allows you to defer a portion of the capital gain on the sale, and the associated taxes, by claiming a capital gains reserve. Although this "staged exit" would leave you holding debt, it may be particularly desirable if minimizing taxes is one of your main objectives. For more information on the capital gains reserve, please ask your RBC advisor for the article on that topic.

Complex rules may affect the tax implications of selling the shares of your business to a corporation owned by your child. If you're planning to structure the sale of your business in this manner, ask your RBC advisor for the article on intergenerational business transfers to learn more.

Winding up your business

If you're unable to sell your business, consider winding up the operations and liquidating the assets. If you've operated through a corporation and have built up retained earnings

(profit left inside the corporation), you may be able to withdraw the retained earnings during your retirement years as dividend distributions from the corporation. Also, depending on your corporate structure, you can consider reorganizing to consolidate or simplify your ownership holdings to minimize costs and administration.

4. What does my retirement look like?

Wanting to retire is the most common reason business owners exit their business. With retirement, you'll have to ask questions like: *Will my retirement income be sufficient? Am I primarily relying on the proceeds from the sale of my business?* To assist in answering these types of questions, you should run cash-flow and net worth projections with alternate scenarios. Speak to your RBC advisor about having a comprehensive financial plan or retirement projection done.

In planning for retirement, you may also consider whether it's beneficial for your company to set up an individual pension plan (IPP).

What's an IPP?

An IPP is a defined benefit pension plan that your company would establish and sponsor. It's often established to enhance the retirement benefits for key employees or for you, the business owner, since it can provide greater annual contribution room than a registered retirement savings plan (RRSP). An IPP is designed ideally for individuals between the ages of 40 and 71 who are earning more than $180,000 of employment income. Your spouse and other family members may also benefit from an IPP if they're employed by your corporation.

Contributions to an IPP provide an immediate tax deduction to your corporation and are exempt from payroll and healthcare taxes. In addition, all IPP expenses, including investment management fees, are tax-deductible to your corporation if paid by your corporation, outside of the IPP. It is possible for your corporation to claim a larger tax deduction in the year you establish an IPP due to contributions for past years of service. In addition, throughout the life of the IPP, you'll have other opportunities to take advantage of further corporate tax deductions. For example, an IPP may have a shortfall if there's an insufficient return on its investments. If there's a shortfall, your corporation can make further contributions, in addition to the current-service contributions, and claim a deduction. Lastly, at retirement, your corporation can make additional contributions to the IPP for terminal funding, which is used to fund any remaining shortfall in the plan.

Further to the corporate tax deductions, an IPP has other potential benefits. With an IPP, personal tax is deferred and only payable when you receive the benefit in a future year, potentially when you're in a lower tax bracket. You may also be able to split your IPP retirement income with your spouse, which may further reduce your family's future overall tax bill. Lastly, the assets in an IPP are also generally protected from creditors should your business ever run into financial difficulty. Overall, these plans allow you to set aside a significant amount of tax-deferred income for your retirement while protecting the assets from corporate creditors.

A business continuity plan is a detailed roadmap that identifies your potential successors and provides direction on how you'll transfer business ownership upon your exit. If you haven't already, it's crucial to develop a comprehensive business continuity plan to secure your business' viability.

Even with the potential benefits of these retirement plans, you should perform a detailed analysis of the pros and cons of setting up an IPP. To find out more, ask your RBC advisor for the articles about IPPs.

5. What would happen if I died yesterday?

Review your business continuity plan

A business continuity plan is a detailed roadmap that identifies your potential successors and provides direction on how you'll transfer business ownership upon your exit. If you haven't already, it's crucial to develop a comprehensive business continuity plan to secure your business' viability. Getting a plan in place ensures you can allocate the right financial, human and technical resources to keep your business running during a transition, which ultimately benefits your employees, shareholders, and clients or customers.

You'll want to consider options for transferring the management and ownership of your business should something happen to you. If you're a co-owner of a business, will your co-owner(s) buy your shares or interest in the business if you become incapacitated or pass away? How will this purchase be funded? You should address these considerations with a qualified legal advisor and potentially in a shareholders' agreement with your co-owner(s).

Review your estate plan

Your goals for (and needs from) your estate plan may shift as you prepare for retirement or the sale of your business. This shift presents a good opportunity to review your estate plan to ensure it meets the needs of your current circumstances.

A Will represents the most fundamental element in any estate plan and is essential to ensuring your wishes are carried out with minimum expense and delay. Is your Will up to date? Are the named beneficiaries in your Will or registered plans still your intended or desired beneficiaries? Are there ways to reduce probate fees at the time of your death? For example, if your province of residence permits, you could consider having multiple Wills where a "primary" Will deals with assets that require probate, such as solely owned bank accounts, investment portfolios and real estate, while a "secondary" Will holds the remaining assets that don't require probate, such as your privately held shares.

Do you have a power of attorney (POA) in place? An enduring or continuing POA (known as a protection mandate in Quebec) is a legal document which may become invaluable in the event you become incapacitated and can't yourself perform your normal daily tasks. This document gives another person(s), referred to as the attorney(s), the power and authority to act on your behalf. A POA for property is used to allow the attorney(s) to make decisions about financial and property matters, including your business.

Review your post-mortem plan

It's prudent to consider the potential tax liability related to your business that your heirs or estate may face upon your death and whether any steps should be taken to minimize this potential liability. Should you implement an estate freeze to have a determinable tax liability on death? Think about creating a customized plan to deal with the specific tax issues that may arise.

For example, if you own shares of your business, there may be a double taxation issue at death. First, you're taxed on the capital gain arising from the deemed disposition of the shares at death. The amount of the capital gain is based on the fair market value of the shares of the company on death, which in turn derive their value from the assets within the company. Often, the next step is to distribute assets out of the corporation to your estate or intended beneficiaries, generally in the form of dividends. This may result in both corporate tax on the disposition of assets inside the corporation and then personal tax on the dividend paid.

It's possible to defer this potential double tax by transferring the shares of your company to a surviving spouse or qualifying spousal trust on a tax-deferred basis. There are also other post-mortem tax-planning techniques that may reduce or eliminate this double taxation. Speak to a qualified tax and legal advisor to learn more about post-mortem planning strategies.

Review life insurance solutions

Life insurance solutions may play a fundamental role in protecting your family, business interest and continuity. As a business owner, you have the option of owning life insurance policies personally or inside of your corporation. Corporate ownership has advantages and disadvantages, but it's usually the most tax-efficient to have your company own the policy and pay the premiums directly.

Corporately owned life insurance can provide tax-deferred growth, which is especially attractive if you've maximized your contributions to your registered accounts. Also, when your corporation receives the death benefit from a life insurance policy, not only will it be tax-free, but the total proceeds of the policy less the adjusted cost base (ACB) will be credited to your corporation's capital dividend account (CDA). The CDA is a notional account that tracks tax-free surpluses accumulated inside the corporation. When there's a positive balance in the CDA, your corporation can then issue tax-free capital dividends to your intended shareholders.

Planning ahead

For every business owner, the day will come — whether in one year or 10 years — that you'll be looking to transition your business to someone else. At that point, you'll need a comprehensive succession plan. Planning an exit requires you to think ahead and think strategically, and you'll gain many benefits by starting early with your planning. Begin by asking yourself these five key questions and work through them with your RBC advisor and your team of qualified professional advisors. This framework should start you along the path towards a successful transition, helping you develop an effective succession plan that addresses the goals and objectives for you, your business and your family.

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