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How to realize the value from a private business

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If you're the owner of a private business that has grown in value over the years, much of your personal and family wealth is likely to be tied up in your company. At some point, you may want to access that wealth, whether to fund your retirement, finance a major purchase, or just provide for your family, and you'll want to do it in the most tax-effective way possible.

For many business owners, the most effective way of realizing the value of their business is to sell it. This raises two key questions: who do you sell the business to, and how do you structure the sale?

Non-monetary considerations

Your decision on who you sell your business to may be motivated by non-monetary issues.

For example, you may want to reward loyal employees by offering them the opportunity to purchase the business.

Or you may want to sell to a child or other family member, with your prime consideration being the continuation of the family-run business.

If you have other shareholders, your choice of a purchaser may be restricted by the terms of an existing buy-sell agreement.

For many owners, however, a sale to a

third party may be the most attractive. In this case, you'll want to structure the sale to maximize your tax advantages.

Decision time — sell assets or shares?

If you decide to sell to a third party, you'll need to choose whether to sell the assets or the shares of your company. This may involve some negotiation with your prospective purchaser. In general, vendors prefer a share sale and purchasers prefer an asset sale.

Share sale. With a share sale, the vendor's proceeds in excess of his or her adjusted cost base are treated as a capital gain, which is only 50% taxable. Some or all of the gain may even qualify for the capital gains exemption. In addition, with a share sale the purchaser inherits the liabilities of the business, so the vendor doesn't have to worry about business liabilities arising from actions taken before the sale (subject to any representations or warranties given by the vendor to the purchaser).

You'll want to declare and pay a capital dividend prior to the sale to the extent possible. Capital dividends are paid out tax-free to shareholders from a company's capital dividend account, which is made up of the non-taxable portion of capital gains

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received by the corporation (recall only 50% of a capital gain is taxable). This will have the effect of reducing the purchase price of the business and consequently the amount that is subject to tax.

The tax implications to you of a share sale are usually straightforward. You may have a capital gain, some or all of which may be sheltered by the capital gains exemption. You may also have unused capital losses from prior years, which can reduce the tax you pay on your capital gain.

Asset sale. With an asset sale, there are two potential levels of tax:

- Tax paid by the corporation as a result of the sale of the assets.

Take advantage of the lifetime capital gains exemption

Capital gains are taxed more favourably than other forms of income. Only 50% of the gain is included in income.

In addition, if you are able to claim the lifetime capital gains exemption (LCGE), you may be able to shelter up to \$750,000 of capital gains (\$375,000 of taxable capital gains) from tax. This amount will be reduced by amounts you've previously claimed under the LCGE, and by your allowable business investment loss and cumulative net investment loss at the end of the year.

In order to be eligible for the LCGE, you must be an individual (not a corporation) who is a Canadian resident and who has sold shares of a qualified small business corporation (QSBC).

In general, shares will be treated as shares of a QSBC if the following requirements are met:

- The corporation is a Canadian-controlled private corporation.
- At the time the shares are sold, at least 90% of the assets are used to carry on an active business in Canada and/or are shares of a connected QSBC.
- You have owned the shares for the 24 months before the sale.
- During those 24 months, more than 50% of the corporation's assets were used in an active business in Canada and/or were shares of a connected QSBC.

The rules that apply to QSBC shares and the LCGE are very complex, so if you're considering selling your business, you should consult a tax professional.

- Tax paid by you personally as you take the proceeds of the sale out of the corporation.

Selling assets may result in a larger tax liability than selling shares. It's important to analyze and compare the tax implications of both actions to determine which avenue is more advantageous for you.

The tax implications of an asset sale will depend on the tax position of your corporation before the sale, the allocation of the purchase price, and how and when the corporation's after-tax proceeds are paid out to you and any other shareholders.

In some circumstances, an asset sale can provide a tax deferral advantage if the after-tax sale proceeds are left in the corporation until you need them as corporate tax rates are generally lower than personal tax rates.

If the purchaser insists on an asset sale, you should ask your tax advisor to calculate the difference in the after-tax result to you compared with a share sale. This may lead you to ask for a higher price in exchange for agreeing to an asset sale.

If you do decide on an asset sale, you and the purchaser will have to agree on how the purchase price will be allocated among the assets that are being sold.

The purchaser will typically want to allocate as much of the purchase price as possible to inventory or depreciable property in order to reduce the taxable income that the business will generate in future years (a higher cost base for these assets provides for more capital cost allowance to be claimed as the assets are depreciated). You, on the other hand, will want to ensure the opposite: that the allocation of the purchase price minimizes any recapture of any capital cost allowance previously deducted on depreciable property, or a realization of income on the sale of inventory.

The purchase agreement should specify the agreed-upon allocation and require both parties to file their tax returns in a manner consistent with that allocation.

Sale to other shareholders

In many cases, the company shareholders will have worked out a buy-sell agreement at some point in the company's history, which sets out the conditions of sale and the purchase price (or a method of calculating the purchase price). The sale to other shareholders will almost always take the form of a share deal in which you either sell the shares to the other shareholders or the



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company redeems your shares.

If the company redeems your shares, you will be deemed to receive a dividend for the difference between the redemption price and the paid-up capital (PUC) of the shares (see discussion of PUC below). This is not a desirable result as this difference will be taxed at the dividend tax rate of up to 37%, depending on the province.

A more favourable option is to have the other shareholders purchase your shares directly. The proceeds you receive (in excess of your cost base) are considered a capital gain and taxed at the lower capital gains tax rate (approximately 23%).

If the shares are from a qualified small business corporation, you may also be able to claim the lifetime capital gains exemption (see the sidebar on Page 2).

In addition, the capital gain may be less than the deemed dividend. This would occur where you purchased your shares from the company directly after other shareholders had acquired shares from the company for a lower price. Your capital gain is calculated based on what you paid for your shares, that is, your adjusted cost base (ACB). As noted above, your deemed dividend is calculated based on the PUC of your shares. PUC is calculated by averaging the total amount of shareholder capital that has been paid in full of all shares of the class over the issued shares of that class. As a result, your PUC could be less than your ACB and so a capital gain would be smaller than a deemed dividend.

If your fellow shareholders don't have the funds to purchase your shares, they may want to use funds from the business to finance the purchase. To do this, a new company is usually incorporated on their behalf in order to purchase the shares from you. This allows you to still benefit from the lower capital gains rate, and possibly the lifetime capital gains exemption, on the sale of the shares. However, the transaction must be at arm's length or else you will be subject to a deemed dividend. There are exceptions however; therefore professional tax advice is critical to ensure that the capital gain is not recharacterized as a dividend.

Sale to employees

Similar issues arise if you are selling the business to employees. In many situations, the employees will not have the required funds to buy you out.

To fund the purchase over time, you may want to consider "freezing" the value of the company. You could exchange your

common shares for preferred shares that have a redemption value based on the value of your common shares on the date of the freeze. The employees would subscribe to new common shares with a nominal value. Over time, the company could redeem your preferred shares or the employees could purchase them.

Strategic use of a holding company could bring benefits

If you're selling the shares of your business and you hold the shares through a personal holding company, you may be able to take advantage of "safe income" dividends paid tax-free to your holding company to reduce the purchase price of the shares, and therefore reduce the amount of your taxable capital gain. "Safe income" is, very generally, the corporation's after-tax income earned or realized after 1971.

The point of this technique is to defer the tax on the safe income until your holding company pays it out to you.

A caution, however: this once standard tax planning technique is generally now worthwhile only if you can leave the safe income dividend in your holding company for a long time (about 12 years assuming a 5% annual return on the deferred taxes). Because the capital gains tax rate is now significantly lower than the dividend tax rate and because your holding company will usually pay these monies out to you as a dividend, this technique produces a worse after-tax result where your holding company pays the safe income dividend monies out to you as a dividend in the short to medium term.

Keep in mind, also, that the lifetime capital gains exemption is available only to individuals. So if the holding company sells the shares, the proceeds won't qualify for this exemption. You could claim the capital gains exemption by selling the shares of your holding company, but this may not be appropriate as there are strict requirements to meet in order to claim the capital gains exemption in this manner. However, with proper advance planning, it's possible both to pay a safe income dividend and take advantage of the lifetime capital gains exemption. If you're considering tax planning based on safe income, be sure to seek professional tax and legal advice first.

Non-competition covenants

Whether you sell your business to a third party, other shareholders, or to employees, the purchaser may ask you to enter into a

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non-competition agreement as a condition of closing. Such an agreement will require you not to compete with the sold business within a certain geographical area for a specified period of time following the sale.

Courts have upheld these agreements as long as they're reasonable in terms of both the time period and the geographical area, and are no wider than necessary to protect the purchaser's interest.

The tax treatment of non-competition agreements entered into in conjunction with a sale of shares recently changed. In two decisions in 2003, the Federal Court of Appeal held that payments received for a non-competition agreement could be tax-free. The Department of Finance quickly introduced legislation that will treat amounts received for granting a non-competition covenant as ordinary income. An exception may apply to non-competition payments received as part of an arm's-length sale such that a portion of the payments for the non-competition covenant can be taxed as a capital gain. However, you should review these rules and exceptions with your legal and /or tax advisor to ensure they apply.

Transfer to next generation

Rather than sell the business to a third party or to an employee, you may want to keep it in the family and bring the next generation into the company. However, your kids may not have the funds to buy your shares. Or, alternatively, you may simply want to slowly bring the children into the business over time, while you are still involved.

A common method of achieving this goal is to implement an "estate freeze". As in a sale to employees, you would exchange your common shares of the company for preferred (or "freeze" shares) which will have a redemption value equal to

the fair market value of the company at the time of the estate freeze. New growth shares would be issued to the children (or a discretionary family trust for the benefit of your issue). Any future growth in the value of the company would then accrue to the new growth shares held by your kids (and not to you).

The benefit of an estate freeze is twofold. Firstly, you will maximize the value of your estate upon death as the value of your interest in the company will be limited to the freeze value of the preferred shares, which means less capital gains tax to pay by your estate. Secondly, you will have deferred the tax on the future growth of the company until the death of the next generation (or when they sell). Accordingly, capital gains and other tax exposure on the future growth that would otherwise arise when the assets pass from you to your kids are avoided.

Once you have implemented an estate freeze, you can slowly have the company redeem your preferred shares over time using retained earnings in the company. Keep in mind, however, that any redemptions will be treated as a deemed dividend to you. Alternatively, if you don't need the cash, you can simply let the preferred shares remain in place, and upon your death, your estate will realize a capital gain on the preferred shares (which is only 50% taxable).

In all instances, it's best to review your objectives, your possible courses of action, and the potential results with the input of appropriate qualified professionals. The manner of the sale can have far-reaching tax, estate planning, and legal implications. You'll want to feel confident that you are making the best decisions for you, your family, and your business.

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For what matters.

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