

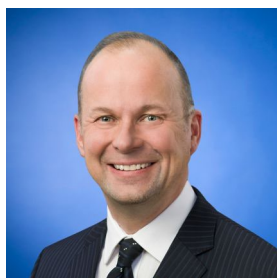
Enterprise Tax on Demand

Selling smart: Getting savvy on divestiture and intergenerational business transfer

Episode 4 - Selling smart: Getting savvy on divestiture and intergenerational business transfer

Family businesses are time-honoured institutions for a reason. Founding owners often have a plan to see the business grow beyond their years of personal involvement, by keeping the business in the family, selling it to a third party, or transferring ownership to employees or a management team. Each route has benefits and challenges. This episode introduces a range of available divestiture and intergenerational transfer options, and shares tips on how to structure a sale with foresight and planning.

Speaker: John Tobin, Partner, Enterprise Tax



John is a Partner with our Enterprise Tax practice based in our Calgary office. John has been providing a wide array of tax advice to various companies for over 25 years including tax compliance/advisory, succession planning, spin-off transactions and M&A deal advisory. He has provided tax services to NPO's and charities including structuring to conduct an unrelated business such as land development as well as working with charities undergoing Canada Revenue Agency audits. John, a graduate of the University of Regina, has been a member of the board of directors for a number of NPO's and charities and a member of the Advisory Group of the Canadian Association of Family Enterprise. He has presented on tax related matters on numerous occasions including seminars hosted by the Law Society of Alberta, the National Judicial Institute, and the Canadian Association of Family Enterprise. John has testified as an expert on tax matters at trial on a number of occasions.

Episode highlights

Time	Topic
00:00 – 01:23	Introduction
02:58	Three ways to divest:
02:58 – 07:15	1. Arm's length sale
07:15 – 9:34	2. Intergenerational transfer
09:34 – 10:55	3. Management equity participation
10:55 – 12:04	Summary and conclusion

For more on the Enterprise Tax on Demand series visit kpmg.com/ca/enterprisetaxondemand

John Tobin

Hello everyone, I'm John Tobin, a tax partner at KPMG in Canada and I'm pleased to welcome you to the fourth episode of our Enterprise Tax on Demand series, which digs into all aspects around the life cycle of a business

In earlier segments, my partners discussed starting and building a family business. In this episode, I'm going to talk about the divestiture, or transfer, of the family business. This could include a third-party sale, an intergenerational transfer, or a partial liquidation event, such as selling part of the business to the management team.

I love working on divestitures as a tax professional. It's satisfying to help successive generations of a family transition the ownership and operations of its family business.

One family I've worked with for 30 years was able to sell its operating business but continues to hold onto the business's real estate. The proceeds from the sale and the subsequent real estate activity has sustained three generations of the family.

In another situation, I helped a founder transfer his business to his son, who then initiated a process to transition the operations to a management team over several years. The succession process took about 10 years, with the business being owned and operated smoothly throughout – first by the Father, then by the son, and then by now two successive management teams.

In divestitures, one of the first things to consider is whether the business is properly organized for a transition event. Ideally, this should be done two or three years prior to any sale or transfer. Next, make sure all the information related to the business is up to date. Do some analysis to figure out what potential purchasers will need to know before closing a transaction. Issues you don't address beforehand will be discovered during due diligence and could impact the transaction. If anything is out of place, address it or be prepared to address it during discussions with the purchasing party.

Some standard steps to put your house in order include:

- Doing a detailed minute book review. Compare it to your financial reporting to make sure all dividends are appropriately declared, and that ownership is accurately reflected by the share register and share certificates.
- Do a tax review, especially for any cross-border transactions. These are a higher risk area and will be a key focus for due diligence teams. If the business maintains any US operations, make sure all American federal, state income, and sales taxes matters have been addressed.
- Get comfortable with the fact that others will be closely scrutinizing all aspects of your business.

There are 3 general ways to divest, and I'll talk about them one by one.

- First, Arm's length sale.
- Second, Intergenerational transfer
- Third, Management equity participation

1. Arm's length sale

Sometimes businesses are approached with unsolicited third party offers. Usually, businesses go to market to find interested buyers – hopefully multiple buyers, to maximize the value of the business through competitive tension. In either situation, it's important to involve experienced transaction or deal advisory specialists to help maximize value for you, the seller.

There are many ways that the deal advisors can help but three main ways are: through minimizing working capital targets, through alternative payment arrangements like earnouts, or by deferring part of the proceeds.

With respect to the working capital targets, buyers want these to be as high as possible, so they effectively acquire excess working capital without paying for it. Sellers, on the other hand, want targets as low as possible. Corporate finance professionals can position an appropriate working capital target based on the requirements of the business. Doing it early and presenting it to buyers up front gives you control and reduces confusion around what's being acquired through any preliminary offers.

The second way to maximize value is through an earnout. This is where part of the sale proceeds are paid over time based on the future performance of the business. This arrangement helps the buyer and seller find common ground on the value of the business. However, as the seller in this arrangement, you take on risk. In addition, you'll need to consider if an earnout meets the tax requirements for capital gains treatment. Questions to ask beforehand include: Can the earn out be calculated appropriately even if the business changes in the future? Is the earnout obligation enforceable so amounts due are easy to collect?

In the third case, you may be in a position to increase the total proceeds by undertaking part of the financing for the buyer. You'll need to make sure the obligation is properly secured so that collection risk is minimized.

It's a good idea to check in with experienced deal advisors, like the KPMG Corporate finance group, for guidance on any of these deal matters. They can help ensure maximum before-tax proceeds to the family on arm's length sales.

To return to the main topic being tax, when selling a business, one of the first questions people are interested in, after "How much tax will I pay?" is whether it's a sale of shares or a sale of assets. Typically, sellers prefer share sales and purchasers prefer asset acquisitions.

Why? First, from the sellers' perspective, proceeds from a share sale are more likely to be treated as a capital gain, which has a lower tax rate. It also might be eligible for the capital gains exemption.

Episodes 2 and 3 have more on that – specifically, on how the appropriate planning in advance of a sale may allow for multiple family members to claim the capital gains exemption.

In most cases, it's the job of the deal advisory team to get the buyer to agree to a share sale. The best way to do that is by keeping a well-managed company with low risk of unanticipated liabilities. That combined with the fact that buying shares is often easier from a customer and supplier relationship perspective should help persuade the buyer that a share deal is the right way to approach the transaction.

Sometimes a share transaction can't be done and at times it's not the best option for the seller. Your KPMG tax advisor can help review the possible transaction structures and advise on the best approach. In cases where the buyer insists on an asset purchase, oftentimes a hybrid transaction can be arranged. This approach the assets the purchaser is targeting in a new company and might allow for the sellers to claim the capital gains exemption.

With respect to third party sales, I'll leave you with a couple of thoughts.

One, if you receive an unsolicited offer, give us a call before signing any letter of intent. Even though it might not be binding, it may inadvertently start you down a less-than-optimal sales path, after which point it might be difficult to get the buyer to consider alternatives. Two, we do our best to make share transactions involving dispositions by individual shareholders are eligible for the capital gains exemption, where possible. Each eligible exemption can shelter a capital gain of up to about \$970,000 from tax.

2. Intergenerational transfer

In this case, the objective is to transfer the business, but keep it in the family. This can be accomplished through an estate freeze and/or a partial or complete sale to the next generation.

In episode 1 of this series, my partner Dino Infanti talked about some relatively new provisions that may allow business owners to sell shares of their family business to corporations controlled by certain family members and enjoy a similar favourable tax treatment as an arm's length sale. Accordingly, families can plan ahead for those kinds of intergenerational transfer opportunities, where some part of the transaction triggers a gain for the business owners – often the parents – which could presumably be sheltered with the capital gains exemption.

To look closer at intergenerational transfer, let's revisit the family business discussed so far in this series – a window and door manufacturing company, owned jointly by the parents of three children

Perhaps the parents want to transfer the business to their children who are active in the business – a daughter and one of their sons. Let's say their other child has a good career outside of the business, so doesn't play an active role.

An estate freeze is typically accomplished by the common shareholders – the parents in this example. They exchange their common shares for fixed value preferred shares equal to the value of the company. Then, new common shares are issued to family members, or a trust with family members who will further the business as beneficiaries. In this case, the common shares could be limited to the daughter and the son, although the other child can also be included in the ownership. Over time, the business redeems the preferred shares held by the parents to fund their lifestyle, and effectively transitions the window and door business to the children. The business is essentially funding that buyout by way of a longer-term payout on the preferred shares. Again, it might be possible to employ the parents' capital gains exemption.

Keep in mind that a valuation of company shares will be required because there is no arm's length transaction. This valuation is usually done by a Chartered Business Valuator, or CBV. Family business or office advisors can also be a big help in ensuring that business decisions suit the family dynamics.

3. Management equity participation

This approach is, in some ways, a combination of the arm's length sale and the intergenerational transfer. In a typical scenario, key management figures are included as owners. By doing so, the founding owners are assured that those individuals are fully engaged in the business. Plus, they get some time away from actively managing the business.

How does the divestiture proceed? It might involve selling the management team part of the common shares for fair market value. It might involve a partial freeze, to let the management team participate further in the growth of the business without obliging them to invest in common shares at their current value. The company could also issue shares to the management team under a stock option plan, providing them with equity at perhaps a discounted price.

Including non-family members as owners in the business might provide some liquidity, but it adds complexity. Decision making will now include non-family members, and a clear division will need to be made between the family and the business.

Because this arrangement includes arm's length shareholders, a valuation by a Chartered Business Valuator will likely be required to provide the management team comfort that the values are appropriate. A shareholders' agreement – as discussed in Episode 3 – will be essential since the interests of arm's length shareholders and family business owners are not always aligned.

As this discussion has shown, there are clearly a lot of options available to family business owners when it comes to divestiture. In closing, I want to emphasize two important takeaways:

First, make succession part of the ongoing discussion with your family members and advisors. When everyone knows what's being considered, it's easier to plan and make sure the business is well-positioned.

Second, divestiture requires a multifaceted team, including legal, deal advisory, accounting and tax. Make sure your team reflects all the specialized skills and relationships to help you achieve a great outcome.

Thanks so much for joining us today for the fourth episode of Enterprise Tax on Demand. Join us next time when we'll discuss post-sale and monetization.

This video is part of a series that shares thought leader perspectives on key Enterprise Tax topics throughout the lifecycle of a private Canadian company.

Stay tuned for new episodes and visit our site at kpmg.com/ca/enterprisetaxondemand for more information.

Musical outro