

Business Owner's Exit Strategies

a) The Need to Plan an Exit Strategy

3 Triggering Events

Although many business owners find it difficult to contemplate, they will exit the business upon the happening of one of three events. It is certain that one of these events will occur while they own the business, which one is uncertain. The events are:

- **Permanent Disability**
- **Death**
- **Retirement**

This includes the sale of the business while the current owner is alive.

While bankruptcy of the business will also force an owner out of the business it is not an event for which there is ever a plan.

3 Possible Outcomes

Upon the happening of one of these three events there are only 3 possible outcomes that can happen. Again, while it is not certain which one will occur it is certain that one of them will do so. The outcomes are that the business will:

- **Be Liquidated**
This entails selling the assets of the company at whatever auction prices will bring.
- **Be Sold as a Going Concern**
The business is sold and the price received recognizes its earnings potential and goodwill values.
- **Be Continued by Family Members**
Someone in the family is, or will be, in a position to carry on the business in its current form.

The Reasons to Plan

- Some of the above outcomes have better consequences than others.
- Even the best outcomes may have unforeseen drawbacks.
- There are tax effective strategies that can be implemented now that will improve the results of whatever strategy is chosen.
- To protect the true value of the business there are a number of risk management strategies that can prevent the devastation that taxes and forced sales can wreak on a business.

b) Liquidation

The Process

Liquidation is very simply the sale and wind up of a business. All the corporate assets are put on the auction block and are sold off for whatever the market will pay.



Tax Issues

➤ **Recapture of Depreciation**

Many assets, equipment and buildings in particular will have been depreciated over the years in order to obtain a write off against current income. On the company's books is left the 'Undepreciated Capital Cost' (UCC) which is the cost minus the depreciation taken over the years. Some of this depreciation has been 'fictitious' in as much as the price realized upon the sale of the asset will be higher than the UCC or book value.

The difference between the price realized and the UCC becomes taxable income in the year of the sale. This amount is fully taxable at that time.

➤ **Sales**

In the normal course of business, the sale of stock on hand is offset by operating expenses. Upon the wind up of a business there are few continuing operating costs so the profit, even based on reduced prices may be quite substantial.

➤ **Capital Gains Tax**

Many businesses have owned assets, particularly real estate, for a number of years. The sale of this real estate, even at distress prices can result in realized proceeds in excess of the cost of acquisition of the asset. The result is a capital gain. One half of that gain is fully taxable in the year of sale.

➤ **Payment of Proceeds from the Company**

If the business has been carried on as a company, all of the above taxes will have been paid by the business. However, this is not the end of the taxation story. In order to extract the net proceeds from the company the shareholder usually is faced with the payment of yet another level of tax in the form of a dividend. Apart from the tax-free portion of capital gains, the shareholder will pay up to one third of the proceeds left in the company as a tax on a dividend.

Other Issues

Normally liquidation is an option only when the business is owned by one person or his/her immediate family. If a partnership exists the remaining partner is left without a career and is therefore eager to look for an alternative exit strategy for his disabled, retired or deceased partner.

Liquidation in the event of death or disability usually entails a forced sale, which realizes much less than optimum prices for the assets. Significantly depleted values can be expected. When a business owner contemplates retirement, the sale of assets can be better managed and real values could be expected—although this will result in higher taxes as outlined above.

c) Sold As a Going Concern

The Process

Here the owner of the business expects to realize a value for the goodwill inherent in his or her business. Entrepreneurs take additional risk, compared to an employee, but in return for that risk a successful business rewards the owner with additional income in the form of profit. Good will is a reflection of the value of that additional profit. This is tempered by a purchaser's desire for a





higher than average rate of return to reflect the purchase of the business is an acquisition of risk. One common form of valuing this goodwill is known as the multiple of earnings method of valuing a business.

Tax Issues

Tax issues will determine not only the price to be received for the business but also the form in which the sale is made.

Many shareholders believe they will sell their shares. If this is so, they will be able to receive half of the capital gain tax free and probably will be able to utilize the \$500,000 capital gains exemption available to owners of shares of a qualifying small business (care must be taken to ensure the company qualifies for this exemption) to avoid any tax on the first \$500,000 of capital gain. In fact this may be doubled if spouses each own shares creating this amount of capital gain.

This is generally a win for the business owner if s/he is able to sell the company in this way.

For the purchaser it may prove to be a loss. The purchase of assets and goodwill may be better as these are items that may provide write offs against future income. Assets which have their Undepreciated Capital Cost adjusted to the higher purchase item allow larger depreciation against current income. The payment for goodwill may also create write offs in a similar manner.

This is a loss from the seller's point of view. The company will have sold the assets and goodwill. Taxes similar to those in a liquidation will have been realized. The net cash proceeds will now be owned by the company and the shareholder is faced with another tax on the dividend in order to extract the values from the company.

Other Issues

An obvious issue in the event of death or disability is who the purchaser might be. In the case of a sole owner this may be difficult to ascertain. If a partnership or co-shareholders exist the obvious purchaser is the remaining partner. However, is there an agreement that binds the remaining partner to purchase and at what price? The remaining partner should be eager to agree to buy as a sale to an outsider, an unknown quantity, may be disastrous for his/her future career prospects. The problem is whether the remaining partner can afford to buy at the time needed.

At retirement, a planned sale can take place and a purchaser actively sought. This presupposes no partnership exists or all the partners agree to a sale. If this is not the case – can the remaining partners afford to buy or even support a retired partner?

d) Continued by Family Members

The Process

Often regarded as the automatic choice for the small business owner, this option is becoming less common as children become educated in unrelated areas and professions and are less likely to be bound by 'family tradition'. Also many owners recognize the difficulty for children to take over a business enterprise run by one person for the benefit of that person compared to the issues of more than one child wishing to take over the business.





The process simply is to find one child that is ready, willing and able to run the business on a moment's notice. Again, retirement is the ideal time for this to happen but are the children qualified if death or disability strikes today?

Tax Issues

The obvious tax issue is the payment of capital gains tax in the estate. It is one thing to pass on a business free of significant debt, it is another to pass one on that has the government as a silent partner.

Less obvious tax planning strategies would include the necessity to freeze the value of the business at the point in time the children started to run the business themselves. In this way all of the growth can be attracted into their hands and the capital gain will not appear in their parent's estate. Additionally, they will receive all the reward for the hard work, skill and risk of continuing to expand the business.

Some parents may want to, or may need to, have children purchase the business from them. Does the child favour the parent's tax problems and buy shares only to create a horrendous tax burden for themselves? Alternatively, does the parent cater to the tax needs of the child only to end up with a deferred tax problem of their own through a corporate restructuring program that caters to the child's tax planning issues? Are there other ways of solving asset and income management issues for the parent?

Other Issues

If the business is owned by more than one family one must always wonder if the child or children who are to take over are acceptable to the other partner.

Not all of the children will be suitable to be involved in the management of the company. Usually it is preferable these be left out of the ownership of the business. If they are left out of the business is it possible for the estate to be equalized between the children while handing 100% ownership of the company to active children only?

How comfortable is the parent, who chooses not to insist on a purchase of the business, in relying upon their child for retirement income security?

