SEIZE THE OPPORTUNITY

Business Succession Planning

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Have you built a prosperous business through your hard work and perseverance? Are you the kind of entrepreneur who invests countless hours in growing your business?
Every business owner must one day plan for the succession of his business, whether with a view to his retirement, to sell the business to a third party, or to transfer it to a family member or to the employees. In order to properly prepare for that day, it is crucial to develop a succession plan.

The planning, an essential step

A successful transition depends on proper planning. In addition to increasing your chances of success, the strategic plan for the transfer of your business will enable you to ensure its ongoing viability. By surrounding yourself, early in the process, with a team of professional advisors (legal counsel, accountants, bankers, etc.), you will reduce your risk of failure and will more easily achieve the objectives of your succession plan. Don't forget that such a plan can take two to five years to implement. Succession planning is a long-term process. Don't wait until it is too late; start today!

IMPORTANT CONSIDERATIONS FOR THE PURCHASER

- Profitability of the business
- Overall sustainability of the business after the completion of the transaction
- Mitigation of the risks associated with the purchase of the business and the transition
- Harmonious integration of the new management
- Financing at an affordable cost
- Tax planning

IMPORTANT CONSIDERATIONS FOR THE VENDOR

- Value assigned to the business
- Protection of the heritage of the business
- Financial security of his family
- Planning for the future to guard against unforeseen events
- Establishing an exit strategy
- Reduction of his tax bill

Transfer of the business to a family member

Where the entrepreneur wishes to transfer the business to his children or other family members, he must adequately plan the transfer both to protect the interests of his loved ones and the interests of the business. The preparation of a succession plan must take into account the needs and wishes of the entrepreneur, but also the talents and aspirations of his loved ones and the reality of his business. In this context, several legal and tax mechanisms may be used, including the estate freeze, discretionary trust, shareholders' agreement, and last will and testament.

Estate freeze

The estate freeze is a commonly used mechanism for initiating the entrepreneur's transfer of his business during his lifetime. The estate freeze allows one to freeze the value of the shares of the corporation operating the business. More specifically, the purpose of this operation is to transfer the future capital gain of the business to other persons (children, grandchildren), particularly in order to minimize and better estimate the income taxes of the entrepreneur that will be triggered by the deemed disposition on his death.

Where the shares of a private corporation meet certain conditions stipulated in the tax legislation, it is possible in the context of an estate freeze to crystallize the $835,716[1] capital gains exemption available during the individual's lifetime. The crystallization of the capital gains exemption enables the entrepreneur to increase the tax cost of his shares in the corporation and decrease, by the same amount, the capital gain which is realized on the sale of his shares, or the deemed disposition on his death.

Discretionary trust

When considering the succession, it is often difficult for the entrepreneur to decide in advance on the persons who should hold the shares of his corporation after his departure, and the proportion of their respective holdings. The reasons for this are simple: the children may be minors or, if they are no longer minors, they may not yet have settled on their chosen career, or it may not yet be clear that they have an aptitude for leading the business. In such a situation, an estate freeze in favour of a discretionary trust is an ideal solution, particularly because it offers the greatest flexibility in terms of the identity of the persons who will benefit from the income, from the future growth in the value of the corporation and from the control thereof, while also enabling the entrepreneur to retain control of the voting rights in the corporation over a longer or shorter time period so as to ensure the effective transfer of the business.

[1] The capital gains exemption is indexed annually based on inflation. The amount applicable for 2017 is $835,716.

There are numerous tax benefits associated with the use of a discretionary trust in connection with the implementation of an estate plan, including the following:

INCOME SPLITTING

A well-structured discretionary trust allows, in some cases, for the splitting of the income earned by the trust among the various beneficiaries. Such income splitting is effective if the tax bracket of the person who would otherwise have held the shares directly (the entrepreneur) is higher than the tax bracket of the beneficiaries of the trust (the entrepreneur's spouse and children).

CAPITAL GAINS EXEMPTION

Another significant advantage of the use of a family trust is the multiplication of the capital gains exemption. Where the trust holds shares of private corporations and certain conditions set forth in the tax statutes are met, it is possible for the trustee to assign a portion of the capital gain realized on the sale of those shares to each of the beneficiaries, thereby enabling each beneficiary to receive a capital gain of up to $835,716 [1], tax-free (except for the minimum tax, if applicable).

Shareholders' agreement

This document enables the shareholders of a corporation to be made subject to a binding agreement which governs their relationship in order to ensure the harmonious transfer of the assets. The shareholders' agreement may contain provisions dealing with the following subjects:

- the rules for the composition of the board of directors and appointment of the officers;
- the policy on the use of the profits, particularly for the buyback of the securities held by the entrepreneur and the payment of dividends;
- restrictions on the transfer of securities (right of first refusal, tag-along right, drag-along right, compulsory withdrawal).

The shareholders' agreement should also provide for what happens on the death of a shareholder. It is at this stage that the entrepreneur should, with the assistance of his advisors, assess whether his corporation should take out a life insurance policy. The life insurance proceeds received by the corporation on the shareholder's death will be used by the surviving shareholders to buy back the deceased shareholder's interest through various mechanisms (purchase/ redemption).

Will

The transfer of a business to the entrepreneur's family members will not be complete without a proper will adapted to the chosen strategy. The will must reflect the succession plan that has been put in place.

Transfer of the business to a partner, the management team or employees

While business transfers through the mechanism of a buyout by the management team or key employees is a strategy that is gaining in popularity, this type of transaction is not suitable for all businesses because of its complexity and prerequisites.

Where the transfer of the business to family members is not an option, the senior management is often an obvious choice for the succession, so that the business can retain the skills they have acquired in operating the business. However, these corporate executives must have the necessary interest, a taste for risk and sufficient financial means to assume ownership. Often, senior managers may be interested and motivated to participate more actively in the business, which can serve as a good foundation for a potential transfer process. However, difficulties inherent to this type of transaction may complicate matters.

Starting the negotiations

Firstly, choosing one's successor or successors from among a talented group of managers is not always easy or clearcut. Starting negotiations for the sale of the business in a context in which these employees must continue performing their regular duties for the business can be a delicate process.

An atmosphere of respect and tact will be necessary in order to engage in a dialogue on the key points of the purchase transaction, while maintaining the employer-employee relationship. Finally, special attention must also be paid to the financing, since this is a frequent obstacle to a buyout by senior managers or key employees. On the other hand, such difficulties will often be quickly forgotten where the proposed transaction gives the parties the opportunity to keep the business running, nearly without interruption, by retaining the acquired know-how of the new principals.

Vendor participation in the financing

When the business is being transferred to the management team or some of its employees, financial institutions will appreciate some financial participation by the vendor and the purchaser, demonstrating their mutual confidence in the future prospects of the business. For this reason, the financing structure will frequently involve the combination of an unpaid balance on the purchase price by the vendor and the contribution of personal funds by the purchaser, in support of the loan advanced by the financial institution.

This being said, financial institutions are usually quite willing to finance this type of acquisition because the risks of a turbulent transition are frequently lower than those associated with a sale to a third party. This is because the purchasers are already familiar with the business and already have a well-established relationship with the clients, suppliers and employees. The assets of the business being purchased or personal assets of the purchasers can be used as collateral security by the lender.

Transfer of the business to a third party

The sale of one's business to a third party or acquisition of a third party's business, as the case may be, can be a complex process that must be meticulously planned and organized. Before getting too far into the discussions and exchange of confidential information, it is standard procedure to sign a confidentiality agreement. This will enable the parties to get the due diligence process underway and also serve as a framework for it. In some cases, a letter of intent or letter of offer, with more or less restrictions, will follow in which the parties will set down in writing the principal terms and conditions which they want to govern the negotiation and completion of the transaction. The transaction is usually evidenced, legally, in a purchase agreement whose form and content will be variable, depending, in particular, on the complexity of the transaction, the conditions precedent to it, and the parties' rights and obligations.

While the vendor will wish to maximize his sale price and chances of collecting the full amount within a short timeframe, the purchaser will want to ensure he pays a fair price and, in return, that he receives the full value of the business he is acquiring. In this respect, the purchase agreement may sometimes provide for the payment of the purchase price in several installments or the payment of part of the price into the hands of a third party depositary. The vendor will give representations and warranties in support of his undertakings under the agreement that will be linked to a compensation mechanism to protect the purchaser and his investment. The representations and warranties normally deal with such issues as the environment, financial condition, intellectual property, litigation, employees and material contracts.

Properly structuring the transaction

There may be various analyses and negotiations on the structure of the transaction itself, dealing, for instance, with tax issues and the rights and obligations of the contracting parties within the business. This process will determine, for example, whether the parties decide on a sale of shares or assets, a merger or a reorganization prior to the closing.

Tax considerations

From a tax standpoint, where the vendor is an individual, he may in some circumstances prefer a sale of the shares of the corporation to a third party, rather than a sale of its assets, if he is able to benefit from his capital gains exemption, which is $835,716 in 2017. On the other hand, the purchaser will normally prefer to purchase the assets so that their full value is available for depreciation. Also, on the purchase of the assets, the purchaser does not inherit the corporation's tax history, that is, the potential tax liabilities owed by the corporation to the tax authorities nor is he responsible for any other commitment made by the corporation. However, it should be noted that several other tax factors must be taken into account before proceeding with a sale of the assets or shares of a corporation.

Vendor's undertakings

Sometimes the purchaser requires the vendor to give an undertaking not to compete with it, or solicit the clients and employees of the business being acquired, for a certain period of time. The parties may also agree that the vendor will retain an interest in the share capital of the business and/or that he will act as a consultant during a transitional period.

Identifying the applicable statutes

In all cases, one must thoroughly verify the provisions of the applicable statutes, particularly the laws governing the industry in which the business operates as well as the laws of general application such as the *Competition Act* and the *Investment Canada Act*.

Financing of a purchase transaction

WHAT ARE THE ADVANTAGES OF A VENDOR FINANCING?

In a context in which the vendor has sufficient confidence in the future profitability of the business and its ability to pay off the debt it will be carrying after the acquisition, it may be advantageous for the vendor to grant financing to the purchaser in the form of a balance on the sale price. On the one hand, this will help the purchaser to set up the credit facilities that he may have to obtain from a financial institution. On the other hand, the vendor may obtain a certain return on this loan, based on an agreed interest rate or even the future profits of the business. Furthermore, if certain conditions are met and the transaction is properly structured, a balance on the sale price may be an attractive tax strategy for deferring the recognition of a part of the capital gain.

WHAT ARE THE POSSIBLE SOURCES OF FINANCING?

The vendor will frequently participate in the financing of the sale of the business, particularly when the sale is to a family member or to the management team or employees.

This is not unrelated to the fact that in such circumstances the vendor has a special interest in the successful completion of the transaction, and that the transition be a harmonious one for all parties concerned. For example, it is possible to provide for an unpaid balance on the sale price that is made payable according to specified terms and conditions, with a fixed or variable interest rate, and even a clause providing for the adjustment of the sale price based on specific financial objectives to be met over a given period of time. It is also possible to consider a mechanism for the phased purchase of the shares, or a loan to the new business, which is usually secured by specific assets of the business or the purchasers.

As for the financial institutions, several factors will influence the type of credit they will grant and the conditions for doing so, including: the type of business being acquired, the acquisition structure, the value and type of assets held by the business (whether tangible or intangible), the capital structure before and after the acquisition, the quality of the collateral security that can be given, the past results and growth prospects in light of the prospective change in control, the management team in place following the transaction, etc.

For more information on our services and to contact the members of our team, please go to our website at lavery.ca (under the heading "Expertise" / Mergers and Acquisitions, Taxation and Debt Financing and Banking).

Published by the Department of Marketing and Business Development, June 2017.

The next generation

For the children or grandchildren who will be taking over the family business, it is important that they fully understand the entrepreneur's succession plan and the role he has assigned to them. They should participate in the meetings with the professionals and not hesitate to ask any questions they may have so that they get a proper understanding of the structure being put in place and the planned changes to this structure.

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