



When a small business changes hands

There are several key challenges to consider when you transfer ownership of a small business. The benefits can be considerable if you do it with care.

When a prospective buyer arrived at Reg Gilchrist's door years ago with an offer to purchase his company, he had little choice but to accept the proposal. Gilchrist, one of Canada's best-known distributors of coin-operated games, shuffleboard and pool tables and vending machines, had run his Toronto-based company for more than 40 years. His son, Tom, had left a promising sales career to join the company and would have bought the business himself, but at the age of 25, couldn't come up with a competitive offer. Nor could he pay the taxes on the company if ownership were transferred to him. So Reg Gilchrist sold his business, then helped his son start another one, called T. W. Gilchrist Vending Co.

Looking back on that period, Tom Gilchrist says it was a difficult decision for his father. If his own children decided to join the newer family business, Tom says, "I'd lay out the carpet for them."

About one million businesses currently operate in Canada with 100 or fewer employees. Like Gilchrist, their owners have to plan now for the time when they sell their company or pass it on to their family or beneficiary. In fact, a few hours of planning now could save a lot of time and money in the future and could even make the difference between selling the business or keeping it in the family.

With the help of a financial advisor, an owner can develop one of several possible plans that will minimize taxes and maximize the value of the company when it passes to the next generation:

- Make full use of your lifetime \$500,000 capital-gain exemption, if available (this applies only to incorporated companies)



- Consider an estate freeze, which allows you to retain control over the business while freezing the value of your interest in it so you can pass future growth on to the next generation

- Purchase life insurance to address an anticipated tax liability in your estate or to keep the company afloat while your beneficiaries search for a buyer or reorganize the management team

DETERMINE THE VALUE

In planning to transfer a business, an owner first has to assess the value of the company. The value can be determined in several different ways, advises consultant, author and teacher Laurence Ginsberg

- **Adjusted balance-sheet or asset book value:** The price is equivalent to the present value of a company's tangible and intangible assets (goodwill, for example)

- **Asset replacement value:** "The value of the assets on a company's books may not reflect the real cost of their replacement," says Ginsberg. "You have to determine this cost to get a truer picture of the company's worth."

- **Discounted future cash flow:** This method is based on the current value of the company's future earnings. You determine the company's value and earnings over the next five to 10 years, then divide that figure by a number that reflects the risk that the business will not meet these expectations

- **Comparison:** Compare the business you want to sell with other businesses in the same industry that have recently been sold. "The drawback with this method," Ginsberg says, "is that you might think you're comparing apples to apples when you're really comparing apples to oranges." The other business might have 10 employees over the age of 50, for example, or its plant might have sprung a leak in the basement





CONSIDER AN ESTATE FREEZE

If you decide to transfer ownership of the business to your children, you can reduce taxes during your lifetime and at death through the use of an estate freeze.

“An estate freeze allows business owners to crystallize their lifetime \$500,000 capital-gain exemption, if still available, and pass on the future growth of a business to their children,” says John Natale, a member of the Tax and Regulatory Services Group at Manulife Investments in Waterloo, Ontario.

The parents essentially freeze the value of their shares, Natale says, by exchanging them for preferred shares, with a redemption/retraction value equal to their fair market value and issuing new common shares to their children. “Any additional growth in the value of the business will be reflected in the common shares, which are now held by the children,” Natale says.

In addition to utilizing the \$500,000 capital-gain exemption and shifting the future growth in value of the company to your children, Natale continues, you can now quantify the taxes payable on death and allocate assets or purchase life insurance sufficient to pay the taxes owing.

Life insurance can be used not only to settle the tax liability at death but also to fund a shareholder buy-sell agreement or provide a cash infusion to keep the company viable while the owner’s heirs try to sell it. As well, business owners could consider buying certain personal investment products, such as segregated funds and Guaranteed Interest Contracts (GICs), through a life insurance company in order to enjoy creditor protection on those investments.



CANADIAN BUSINESS FACTS

Number of small and medium-size enterprises (SMEs) in Canada as of June 2002:	2.2 million
Maximum number of employees needed, according to Industry Canada, for a goods-producing company to be considered "small":	100
For a service-producing firm:	50
Above that number, a business is considered medium-size when it employs up to this many employees:	500
Percentage of SMEs located in Ontario and Quebec:	58
In the western provinces:	35
In the Atlantic provinces:	6
Percentage of SMEs that are goods-producing:	26
Percentage that are service-producing:	74
Of the little more than one million businesses that employ one or more people, the percentage that have fewer than five employees:	58
Five to 49:	37
50 to 99:	3
100 to 500:	2
Percentage of all Canadian businesses that are family-run:	90
Percentage of those that survive for the second generation:	30
Percentage of those that survive for the third generation:	10

Percentage of businesses with fewer than five employees that survive one year of business:	72
Of businesses with five to 99 employees:	89
Percentage of businesses with fewer than five employees that survive five years of business:	33
Of businesses with five to 99 employees:	53
Percentage of businesses with fewer than five employees that survive 10 years of business:	18
Of businesses with five to 99 employees:	34
Percentage of SME owners who say they never work fewer than 50 hours a week:	80
Of paid employees:	14

Sources: Industry Canada, Statistics Canada and the Canadian Federation of Independent Business (CFIB)

Compliments of:

Manulife Investments is the brand name identifying the personal wealth management lines of business offered by Manulife Financial and its subsidiaries in Canada. As one of Canada's largest integrated financial services providers, Manulife Investments offers a variety of products and services including: segregated funds, mutual funds, principal protected notes, annuities and guaranteed interest contracts. WealthStyles, Manulife and the block design are registered service marks and trademarks of The Manufacturers Life Insurance Company and are used by it and its affiliates including Manulife Financial Corporation.

www.manulife.ca/investments

 **Manulife Investments**
With you every step of the way®