

# Succession

## PLANNING



**BDO Dunwoody LLP**  
Chartered Accountants  
and Consultants

## Business Succession: A game of options

**B**renda Buckley was in a quandary. Never married, she had given most of her free time to building the business. Now Brenda was approaching retirement, but she was concerned that she wouldn't get enough from selling the business to fund a comfortable retirement. Business was off a little lately, and she'd spent a fair bit of her savings on nursing care for her mother. What could she do?

Brenda felt trapped, and these traps come in all shapes and sizes. Some business owners may be torn between two children who want to lead the company; others may have children who are not qualified, or not interested. Still others may have health problems that force business decisions at awkward times. Yet at some time, every business owner needs an exit strategy.

Whether you pass on the business to your family, or sell the business to employees or third parties, the transfer of your business is a process rather than an event. In other words, business succession is not a game of inches—it's a game of options. Actually, there are six basic 'off-ramps' you can choose. Let's look at each of them:

### 1. APPOINT A FAMILY MEMBER

In many cases, business owners are fortunate to have children who have 'lived' the business, worked in the business and have grown up with an understanding. However, they are not fortunate when two or more children are capable of running the business, and interested. Difficult choices need to be made, and the next article in this newsletter deals with the tender subject of separating business imperatives from family emotions.

Some business owners forget that a family member doesn't have to be a child. In our opening

example, Brenda Buckley probably has an heir to whom the business assets would pass upon her death. This may be a younger brother or sister, or

## Family Business Succession Options



a cousin. Would they, or could they, take control? Perhaps a niece or nephew who has worked summers at the business would jump at the chance to carry on.

### 2. APPOINT A CARETAKER MANAGER

A caretaker manager allows the business to carry on and provide an income for you until a time in the future when you intend to sell or wind down. Your choice here could be a family member, or a non-family professional manager. This arrangement may allow you to semi-retire, keeping your knowledge and contacts at work for the business.

Any substitute manager you choose must be properly trained in the functions of the job, the business model, the industry and its competitive realities. He or she must gain the confidence of key customers and suppliers. Start this process as early as possible, working side-by-side for several years if possible.

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### 3. APPOINT A LONG-TERM PROFESSIONAL MANAGER

By appointing a long-term professional manager, you can keep the business as a going concern beyond your death, generating income for your heirs, hopefully throughout their lifetimes. The same training principles apply to a professional manager as a caretaker manager, but the arrangement has a decidedly different 'feel'.

In most cases, hiring a professional manager while retaining the majority of ownership can be a risky proposition. Will you be able to retire and not worry about the business while you need its value to fund your retirement? Will

things go as you intended when you're not around, or are you giving your heirs more responsibility than they are prepared for? This is not to say that the arrangement can't work well if all the issues are addressed.

### 4. WIND DOWN THE BUSINESS

It's important to pinpoint where, exactly, is the value in your business? Does it reside in the strength of your brand, your licenses, and your contracts? Perhaps it's found in your own specialized knowledge—or the knowledge of a small group?

If you think the business would not continue without you, it may be better

to plan to wind down the business. Aside from the legalities of this process, there are probably some assets to liquidate, such as inventory and equipment.

### 5. SELL THE BUSINESS

When a successor can't be found within the family, the most popular option is to sell the business to a competitor, or to the management/employees of the business.

Selling your business properly and receiving full value is a complicated process that involves legal and tax consequences. It is a subject beyond the scope of this article, but we strongly recommend the use of a professional advisor to help you.

## Family Business Succession: The Keys to Success

**F**amily-owned businesses are the mainstay of Canada's economy, generating more than 45% of the Gross Domestic Product. Yet about two-thirds of all family businesses do not survive the transition to the second generation and another two-thirds of those fail to survive to the third generation, according to the Canadian Association of Family Enterprise (CAFE).

Why is this happening? Mainly because very few family businesses have an orderly approach to succession; only a small minority have a written plan. Without this planning, the operation can become unstable as the current owner-manager eases into retirement. Working capital and investment capital can erode. Personal wealth can erode due to tax and legal consequences, along with poor investment decisions. Finally, ignoring succession can have a devastating impact on something more important than money—family relationships.

The vast majority of failures in family

business successions occur because of family dynamics. This can include a lot of different elements: sibling rivalry, competing visions for the business, lack of a suitable successor, and disagreement about parental roles or rights. Without a plan to deal with these issues, they can become paralyzing. The family priority becomes avoiding open conflict; a fact that may end up reflected in the quality of the business decisions.

While succession planning isn't always easy, it is worthwhile. Too often perceived as an event, succession planning is actually a process that takes time. Here are some keys to success.

### 1. START THE PROCESS EARLY

In many cases, business owners have given thought to succession, but have put off the hard planning and implementation. The sooner you start the process, the better your chances for success.

### 2. ESTABLISH A CLEAR TIMETABLE FOR THE PROCESS

A clear timetable helps those involved know exactly what will be expected of them, and when. Vague time references should be avoided; for example, saying you will continue to work until the day-to-day responsibilities become too much for you. That puts your successor in a 'Prince of Wales' situation—waiting for your misfortune to assume the throne.

At a minimum, dates should be set for the following events:

- The business owner's retirement
- Transfer of share ownership
- Transfer of voting control

Barring unusual circumstances, you should stick to your specific timetable once you have set it. The entire plan's credibility will suffer greatly, for all concerned, if the timetable is not followed.

## *Business succession is not a game of inches—it's a game of options.*

### 6. DO NOTHING

Although doing nothing is rarely a conscious choice, it is still the most common choice made by business owners.

According to some surveys, business owners often say they don't have a succession plan because they intend to sell their businesses. What they perhaps don't realize is that selling is just

another form of succession. A plan is just as important under this course of action as for any other. To test this scenario, just imagine what would happen if you became disabled today. Would your business survive until a purchaser is found?

Despite what some might wish, ignoring the issue won't make it go away. There will come a time when, whether due to changing priorities or maybe even health issues related to

advancing age, you will need to decide what happens next. Not making a decision could create a scenario where your heirs or future heirs may be making important decisions about the business without the benefit of training or experience. In many cases like this, an otherwise viable business has to be sold at a distressed price and with possibly adverse tax consequences. The asset can become substantially devalued.

This brief examination of succession options may help you get started on your own succession plan. With any option you choose (except for number six) there is work to do. The earlier you start, the easier it will be.

### 3. KEEP THE SUCCESSION PLAN AS OPEN AS POSSIBLE

Family dynamics at work in a business can boil down to "who said what to whom, and what did it mean." Your succession will have a much better chance for success when everyone involved has a clear understanding of the strategy, the planning and the implementation. In particular, each individual's role should be clearly understood.

One of the best ways to make this happen is to document the succession plan, and make it available to those directly involved in the succession process. Be careful not to make unofficial verbal amendments to the plan unless it is in the context of a family meeting about the plan. In this case, be sure to amend the written plan to reflect the changes or decisions made at the family meeting.

Most family business advisors recommend meetings convened specifically to discuss succession, which allows your family to focus all their attention on the issues it presents. Holding these meetings at a neutral site away from the business or the home is recommended, but discussing business at family events is definitely not recommended.

It is also advisable to make essential non-family employees, customers and partners aware of your succession plans.

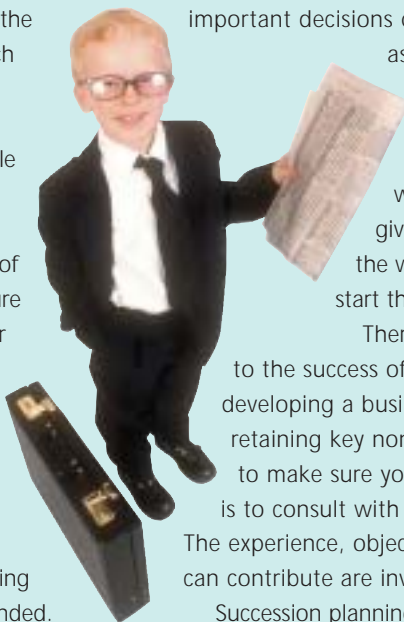
### 4. CLEARLY IDENTIFY YOUR SUCCESSOR

To be effective, your succession plan should clearly identify who will succeed you and what that person's role will be. Most successful succession plans designate one overall leader. With a strong leader comes the ability to make important decisions quickly and capitalize on opportunities as they arise.

This may be the toughest part of succession planning, especially if you have more than one capable child who wants the job. If you have to choose one, give special consideration to the others in the way of ownership or perhaps capital to start their own businesses.

There are other factors that can contribute to the success of family business succession, such as developing a business plan beyond your retirement, and retaining key non-family executives. However, one way to make sure you cover as many of the bases as possible is to consult with advisors, legal and professional. The experience, objectivity and professional skill they can contribute are invaluable to the process.

Succession planning pushes most owner-managers out of their comfort zone, which means it's a low priority and usually gets put off. With a deliberate attitude and approach, succession can be dealt with once and for all.



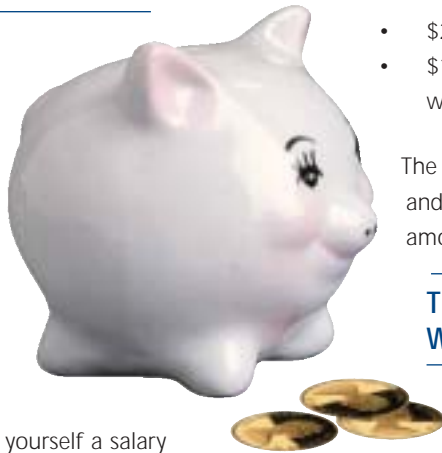
## Business Owner: Plan Thy Retirement

**E**mployed executives can usually rely on a pension plan to provide the majority of their retirement incomes. For you, the business owner, it's not as straightforward. Over the years, a lot of your retirement nest egg has been invested as equity in your business. How are you going to fund your retirement; by maximizing the value of your business, or by withdrawing funds from the business to generate personal retirement savings?

### SAVE SOME MONEY FOR RETIREMENT OUTSIDE THE BUSINESS

The strategic answer is a bit of both. The best reason to hold some of your retirement savings outside the business is risk reduction. By taking your profits when you can, you protect them against potential future business losses. You'll also be able to take advantage of the personal income tax deferral made possible by an RRSP (if you pay yourself a salary instead of dividends), and diversify your retirement investments among different asset classes. If it comes time for your children to take over the business, you'll have an independent source of income and be less of a drag on cash flow.

Saving for retirement inside your business has advantages too. For one thing, the rate of return on your equity can be far higher than other investments—and you have much more control over it. However, your business investment may be more sensitive to economic conditions, competition and a host of other business risks. On the plus side, however, your investment in a small business corporation may benefit from the capital gains exemption. You may also earn more income that is eligible for small business tax rates in the corporation, rather than higher personal tax rates.



### HAVE YOUR CORPORATION PAY YOU A RETIRING ALLOWANCE

When you retire, your business corporation is entitled to pay you a retiring allowance. This applies whether you retire from a family business corporation, or whether you sell a business corporation to retire. In the latter case, a retiring allowance would be paid just before the sale.

Retiring allowances can qualify for a tax-deferred rollover to an RRSP, subject to the following limits:

- \$2,000 for each year of service before 1996; plus
- \$1,500 for each year of service before 1989, provided you were not a member of a company-sponsored pension plan.

The retiring allowance will be deductible to the corporation, and will not be immediately taxable to you, provided that the amount is transferred directly to your RRSP.

### TRIGGER THE CAPITAL GAINS EXEMPTION WHEN YOU SELL THE BUSINESS

Canadian residents can claim an exemption of up to \$500,000 against capital gains from qualifying shares of a small business corporation (SBC). Some conditions apply, but the corporation only needs to be an SBC at the time of sale. At that time, at least 90% of its assets must be business assets.

Where a corporation does not qualify due to excess non-business assets, you may need to remove some of these assets prior to a sale in order to qualify for the exemption. There are several ways this can be done, depending on the circumstances.

Although there are many points to cover on the subject of retiring from your business, the main thing to remember is that you must never underestimate the importance of succession planning. These things do not take care of themselves, as they tend to with your friends and associates who are employed. It's another one of the many details of running a business, and certainly no less important than any other.

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