As a business owner, what's your succession and transition plan?

Retiring from your own business can be difficult after having invested the better part of your working years to achieve success. And, business owners who want to pass on that successful business may be faced with a bigger dilemma of if and how to transfer the wealth they have accumulated through their business. A number of critical factors need to be considered including how they will exit from their business, the valuation of the business, family considerations and expectations and their own retirement plans.

There are several options to exit the business – from selling it to a third party or current management team to transferring it within the family. The value of the business will also impact how much wealth can be transferred or leveraged for retirement. Finally, has the business owner saved enough to fund their retirement or will they have to depend on the sale of their business or continuing to draw income from the operating business to fund it? These considerations require business owners contemplating a future sale or transition to set their vision, goals and exit plan early which is critical for success.

Turning a business into a retirement asset and sharing the wealth

Two questions must be considered when trying to convert an operating business into liquid assets to fund retirement and pass on wealth to the next generation:

- How much is the business worth?
- What methods are available to convert a business into retirement capital?

Before answering these, business owners must first assess whether it even possible to find a buyer for the business, or to convert the business into retirement funds? If the business operation is heavily reliant on the active involvement of the business owner to generate future cash flows, this may be a barrier to successful succession including the value of the business in the marketplace and the conversion of a business into retirement capital

Exit options for business owners

Private business owners have a number of exit options, some of which will influence the transfer of wealth:

- selling their business to an unrelated person
- transferring or selling the business to a family member
- winding down and closing the business

Business owners considering a transfer or sale within the family must first determine if any family members are interested in assuming ownership responsibilities, and they must help set expectations with those family members on the future management and/or ownership roles. If the family lacks interest, capability and/or drive, the business owner may require additional flexibility when considering exit options. First and foremost, how they exit their business will impact how they transfer wealth.

Challenges to withdrawing from your business

There can be barriers to exiting a business and these make it crucial to formulate a succession and transition plan well in advance of the eventual transition to successfully retire from a business and transfer wealth. Here are some situations that can put your wealth plans at risk:

- **Business in decline** – Putting personal funds back into a business going through a downturn might help bridge the business to better times. Ongoing personal funding of current operations without a long-term revitalization plan could lead to a situation in which such investment might never be recovered.
- **Selling with vendor financing** – Often, a purchaser of a private business does not have the capital, or the ability to borrow sufficient funds, to pay for it outright. This is often the case for a sale to key employees or non-family management team members. To facilitate a sale, business owners often provide financing, expecting repayment over a number of years. If the business does not succeed under new leadership, or the new owners do not honour their financial commitments, you may be left receiving only a portion of the negotiated sales price.
- **Failure of a family business** – Many business owners planning to pass on their business to the next generation put ownership structures in place to allow for continued cash flow, often in the form of dividends, to help provide for their own retirement funding needs. Unfortunately, some family businesses do not survive into a second generation, and so you may not receive the ongoing retirement income you expect.
- **Inflexible business structures** – Sometimes, the availability of suitable cash flow from the withdrawal from a business is restricted by previous planning, such as estate freezes that pass on growth in the business to other owners.

Any of these situations could have a negative impact on the ability to exit from the business effectively, retire comfortably, and transfer wealth to the next generation. Planning to exit from a business includes two fundamental components that should be addressed well in advance of the eventual exit: the transfer of ownership and the transition of management. When planning to exit from the business, owners and their families often initially focus on the transfer of ownership which includes tax structuring and related business valuations, legal agreements, amongst other procedural items. A common area that is often initially overlooked is the transition of management of the business which is a process that requires considerable attention and time. When preparing for exit, it is key for business owners to work "on" the business versus "in" the business ideally building a management team and organization that can operate successfully in their absence in advance of their eventual exit. This serves to de-risk the business, provide flexibility in exit options, and makes the business more appealing to potential buyers.

Valuating a private business

Assessing a reasonable value for a private business is no easy task. Often, there is a limited amount of information available to benchmark a business. When private business owners require a formal valuation of their business, a professional business valuator can be consulted. Often, the result of a formal business valuation is lower than the business owner expected, as the only true value of a business is the amount that a willing and informed buyer will pay. Private businesses can be valued by a number of methods:

- Income approach – applying an appropriate multiple to the value of future cash flows or income;
- Market approach – based on the prices obtained from the sales of similar companies; and
- Asset-based approach – the value of assets in the business, less any liabilities.

> "A common area that is often initially overlooked is the transition of management."

Determining the value of a private business involves a number of factors and is often complex. Simply put, the fair market value of a business is a function of the risk of achieving future cash flows/income. In arriving at the fair market value of a business, a normalized level of sustainable future income is established which requires adjustments to remove expenses of the current business owner not related to operations, non fair market value items, and any anomaly or one-time items. In addition, comparable transactions are scarce given the limited availability of private company transaction disclosures, and it can be challenging to make objective valuations of the physical assets of a business.

How much is enough?

There is no simple answer to the question of how much to save for retirement. Every business owner and their family have their own set of unique circumstances and requirements. The amount of savings required for a comfortable retirement can depend on a wide variety of factors:

- How much do you intend to spend annually in retirement?
- How much can you save each year leading up to retirement?

- How old are you now and when do you expect to retire?
- How will your longevity affect the sustainability of your savings?
- What other sources of income such as CPP, OAS and other pensions will be available to you?
- What about future health care costs and taxes on sources of retirement income?

A personal financial plan can help to put all of these individual factors together to determine the right amount of savings to meet retirement goals.

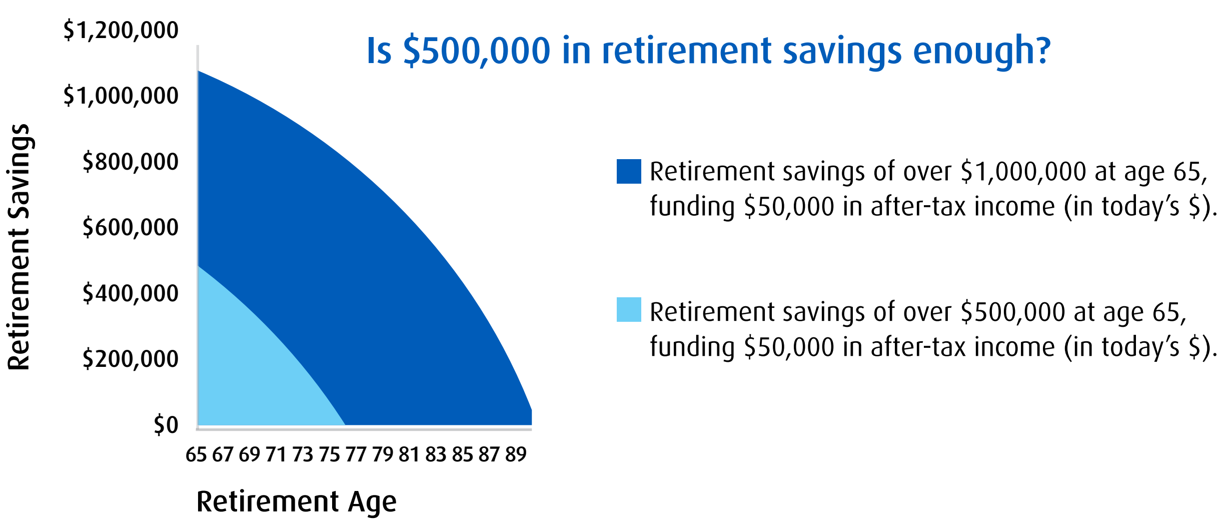
Many business owners may have to rely on the value of their business to supplement their retirement savings to help fund their future retirement income. For example, withdrawing income at a rate of $50,000 per year can cause a $500,000 pool of retirement savings to be depleted in about 12 years (see chart).

For this level of retirement income to be sustainable during a retirement that lasts from age 65 to 90, more than double the initial amount of savings, or almost $1,100,000, will be needed. This sizable difference highlights the importance of being able to depend on the value of your business for your retirement.

Planning for the future

Retirement planning for private business owners can be complex, as it is necessary to have a business succession plan and a personal financial plan focused on retirement that work together well in advance of the eventual transition event. Both of these plans require a personal commitment in order to create an overall retirement plan that can be successfully achieved.

A formal, written business succession plan has many components and its development considers many options. Its purpose is to set an overall process and a time schedule over several years for the business owner's planned withdrawal from the business to ensure a successful transition.



Assumptions: The savings are accumulated in a non-registered investment account with a rate of return of 4% from interest income, taxed at an average tax rate of 20%. The withdrawals of $50,000 in after-tax income in retirement are indexed at 2%. The calculations do not take into consideration any additional sources of income such as government benefits, corporate pension, registered assets or corporate accounts.

Most importantly, it includes both technical concerns, such as legal, accounting, tax and valuation matters and softer interpersonal issues that are of the utmost importance for family members, key employees and other business stakeholders, including ensuring business continuity in the owner's absence. The most successful business succession plans take a number of years to implement and cover both the technical and soft interpersonal issues inclusive of the transition and grooming of management of the business which takes several years depending on the nature of the business operations.

Putting effective business succession and transition, and retirement plans in place

If you are intending to sell your business as part of your retirement plan, there are a number of steps that can be taken in advance, including working with business advisors to de-risk the business to increase commercially transferrable goodwill and the related proceeds of sale, and under the guidance of your taxation professional, to minimize the amount of taxes owed. A business owner may be eligible to receive up to $883,384 from the proceeds of the sale of their shares, tax free, as the result of the lifetime capital gains exemption (2020 figures). Note that this amount increases annually as it is indexed to inflation. Additional long-term tax advantages may also be achieved by the use of holding companies, insurance policies, pension plans (including IPPs) put in place prior to the sale.

> "The most successful business succession plans take a number of years to implement."

An effective retirement plan includes savings outside of the assets of the business that can be used to help fund your retirement. You can diversify your retirement assets by maximizing savings in RRSPs, TFSAs, pooled registered pension plans (PRPPs) and non-registered investments allocated for retirement.

One additional option may be available for business owners that have buildings, land or other valuable assets as part of their business. Even if the operating business cannot be sold and converted into necessary retirement funds, such assets are more liquid and often are quite valuable. However, the tax implications of the sale of any business assets must be carefully considered.

The importance of owning diversified retirement savings personally and outside of your business cannot be emphasized enough, given the risks and challenges in converting business assets into funds that can be used for retirement and wealth transfer to the next generation.

Final thoughts

A business owner's ability to transfer wealth to the next generation will be highly contingent on their plans for exiting the business. The exit from the business will be highly influenced by how they plan to transition the business, the value of the business, and the retirement plans in place to fund retirement. Finally, all of these considerations will impact the transfer of wealth to the next generation.

Working together with BMO financial professionals who understand the needs and challenges of private business owners and their families can help you make the plans necessary both for your business and your personal situation in parallel in order to achieve a financially stronger future.

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