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How Much Is Your Business Worth?

By Jeff Saunders, CPA, CA.* & *Rylan Melles, CPA, CA.
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When we meet with small business owners who are approaching retirement age and who are beginning to plan for selling their business, we frequently ask them how much they think their business is worth. The answer to this question is often very interesting. One of the most common answers is: "In order to retire, I need to get X dollars when I sell the business." Unfortunately this is not the best approach to determining the real value of their business.

We often tell the business owners that the true value of their business is the highest amount that someone is willing to pay for the business. This does not mean that a potential buyer is completely in control of determining the price in a potential transaction. It simply means that the seller needs to be realistic in their expectations as to how much they can sell their business for. The best way to do this is to try to take a fresh look at your business and try to put yourself in the shoes of a potential buyer.

There are multiple factors that drive the value of a business for a buyer. If planning for a sale is done early enough, we can work with the business owner to help them understand these different factors and to focus on improving these factors prior to selling. For example, depending on the industry, some of the steps below can be undertaken to improve the value of the business in the years leading up to a sale:

- Cut operational costs to improve net income (discretionary expenses are normalized in a valuation)
- Raise prices to increase revenue, and secure stable long-term sales contracts if possible
- Increase advertising expense to drive an increase in sales
- Pay down high interest debt to improve the balance sheet (low interest debt improves cost of capital)
- Upgrade to newer, more efficient equipment
- Sell old or underutilized assets
- Don't make yourself irreplaceable – this will increase the risk of your business failing under new ownership, and decrease the perceived value to the buyer
- If there are other minority shareholders in the company, ensure a shareholders' agreement is in place

Another key factor in how much you ultimately receive on the sale of a business is how much tax you pay on the sale. Proper planning in advance can help reduce the tax bill that is triggered by a sale.

For example, if you sell the shares of the corporation, will the sale qualify for the Lifetime Capital Gains Exemption "LCGE"? If it does not currently qualify for the LCGE, are there steps that can be taken to get onside with the complex rules for the LCGE? In some cases the steps to get onside with the LCGE rules must be taken at least two years prior to selling. Therefore, it is essential to begin planning well in advance of the time when you actually want to sell.

Working with the team of Chartered Professional Accountants, Chartered Business Valuators and Tax Specialists at your local DFK affiliate firm, we can help you plan for the sale of your business in the years leading up to your retirement to ensure that you maximize the price you ultimately receive.

Amendments to the Principal Residence Exemption Rules

By Sharon Gross, CPA, CA.
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The principal residence exemption rules permit a Canadian resident to eliminate all or a portion of the capital gain on the disposition of a principal residence. Historically, the Canada Revenue Agency ("CRA") did not require taxpayers to report the disposition of a principal residence if the exemption eliminated all of the capital gain on the disposition. Starting in 2016, individuals who sell their principal residence (including deemed dispositions) must report the sale on their income tax return and make a principal residence designation to claim the principal residence exemption. No three year statute of limitation period will apply in respect of dispositions of real property (not just a principal residence) if the taxpayer does not report it on their tax return.

CRA may assess or reassess the disposition at any time. A taxpayer who fails to report the disposition of a principal residence can file an amended return to correct the omission subject to a late designation penalty. It is unclear whether the principal residence designation will be allowed if the taxpayer reports the sale of the principal residence by amending their original tax return (as opposed to reporting the sale on the initial filing). A new penalty of up to $8,000 will apply if CRA accepts your late principal residence designation.

The "one-plus rule" was designed to overcome the problem when a taxpayer sells a principal residence and replaces it with a new one in the same year. A taxpayer is only permitted to designate one of those properties as a principal residence for that year, raising the possibility that capital gains tax may arise on one of the properties. The one-plus rule will be available only to taxpayers who are resident in Canada in the year the property is acquired.

Under the current rules, a housing unit owned by a personal trust will qualify as a principal residence if the trust designates the property as a principal residence and the designation identifies each individual who is a "specified beneficiary" (an individual who is a beneficiary of the trust and who {or whose current, former spouse/common law partner or child} ordinarily inhabits the housing unit in the taxation year). Commencing January 1, 2017, the trust must be an "eligible trust" one of whose "eligible beneficiaries" is resident in Canada and is a specified beneficiary of the trust.

Eligible trusts include:

- an alter ego trust,
- an inter vivos or testamentary spousal or common law partner trust,
- a joint spousal or spousal trust,
- a testamentary trust that is a qualified disability trust, or
- an inter vivos or testamentary trust the benefit of a minor child of the settlor where both of the child's parents died before the start of the year.

An eligible beneficiary is one where the trust's terms provide the beneficiary with a right to use the housing unit.

The "eligible trust" changes would prevent some trusts that own a housing unit on December 31, 2016 from claiming any Principal Residence Exemption on a disposition of the housing unit. A new transitional rule provides some relief to those trusts. In the year the trust disposes of the property, the gain is separated into two periods. The capital gain that accrued to December 31, 2016 is eligible to be reduced by the current principal residence exemption rules. Any remaining capital gain will be subject to tax if the trust is not an "eligible trust". The transitional rule uses the "fair market value" of the housing unit on December 31, 2016. We recommend that trusts which may have to rely on the transitional rule have a valuation of the housing unit prepared now to support a future claim for Principal Residence Exemption.

US Election Could Affect "Canadian" Estates

By Geoff Brookes, CPA, CA.
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The 2016 US election results are "in the books", and Donald Trump is the President-elect of the US. But the battles over US tax policy will likely be fought long after the votes have been counted. Some tax changes may be determined by compromise due to the complex system of checks and balances in the US political system.

The tax changes could affect the (estimated) one million U.S. citizens living in Canada, who are subject to the US tax rules. But they could also affect larger Canadian estates that hold certain U.S. assets.

President-elect Trump favours an outright repeal of US estate taxes. His opponent, Hilary Clinton, supported tax hikes on high income earners (including a 24% capital gains tax rate). Hilary Clinton also wanted to return US estate and gift tax exemptions back to 2009 levels, when the exemption was $3,500,000 (USD).

Larger Canadian estates can be subject to US estate tax if they hold US assets, including US real estate and certain US securities – even if the deceased is not a US citizen.

The taxable estate value generally includes:

- Life insurance;
- Principal residence;
- Assets or investments, whether there is a gain or not;
- Items that might be tax-deferred from a Canadian tax perspective, such as a "rollover" of an RRSP from a US citizen to a spouse who is not a US citizen;
- Liabilities are generally not considered.

The lifetime exemption amount must be reduced by gifts made throughout the deceased's lifetime, including gifts to a spouse who is not a US citizen.

Examples:

- Five years ago, Karen (a U.S. citizen living in Canada), gave her shares in her Canadian company to her husband Jim (not a U.S. citizen). This was a tax-free rollover from a Canadian tax perspective, since they were both residents of Canada. If Karen should die, her estate would be subject to US estate tax rules because she was a US citizen. If the shares she gave to Jim were worth $2 million USD, and if her life insurance paid $4 million USD, her estate would be subject to US estate tax, even under the current rules, because the total estate exceeded the $5.49 million exemption.
- Jim (not a US citizen) dies with a $6 million estate, which includes valuable US real estate investments as well as life insurance. Jim's estate must pay US estate taxes on a portion of the US real estate value, because the total estate exceeded the $5.49 exemption (USD).

The Canada-US tax treaty may provide relief to some "Canadian" estates. However, the differences in the two tax systems can give rise to surprising tax results.

With the exemption at $5.49 million (USD), estates are often below the US estate tax exemption amount. But if the exemption is lowered to $3.5 million (USD), more Canadian executors might be visiting Uncle Sam to pay their US estate tax bill.