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Exit to Community

A Business Transition Guide for Business Advisors & Business Owners

Written and Compiled by: Laura Bechard, CPA-CGA, MBA, M Ed

Contributors

- **Seth Leon**, MDE, Alberta Community and Co-operative Association
- **Ryan Hoult**, CPA, CA, ICD.D, Managing Partner, Rice & Company LLP
- **Dan Ohler**, Employee Ownership Specialist, ESOP Builders Ltd
- **Mark Shields**, Business Strategist, Business Link
- **Karim Bharwani**, Managing Partner, KBM Accounting Professional Corp.
- **Elizabeth MacRae**, CEPA, Village Wellth
- **Janice Fox**, CPA, CA, Virtus Group Chartered Professional Accountants and Business Advisors LLP

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About this Guide

No business owner wants to be in a situation where their hand is forced, especially at a critical milestone. Unfortunately for many business owners, when it comes to exit and succession this tends to be the case. This guide provides strategies to introduce options that increase the likelihood for success at these critical times.

For business advisors and business owners, this guide intends to reduce the stress of the exit process by offering approaches that increase the benefits of the exit and increase the legacy impact. This guide is not a substitute for the considerable amount of work that goes into exit planning and selling a business successfully. However, our goal is to start a great conversation between business owners and their advisors to understand and explore local solutions. It is intended to stimulate broader conversations with advisors and their clients about viable exit options with outcomes that benefit the business owners, the community, the employees, other stakeholders, and the local economy. This guide is a starting point to a bigger opportunity in our changing economy.

The first section of this guide introduces the process of selling a business, the concepts of succession planning, exit planning and Exit to Community. It explains how Exit to Community supports exit planning by introducing more potential buyers and by offering added legacy benefits for business owners. This section reviews the elements that go into the deal structure and related costs and considerations.

The next sections introduce strategies to make it easier for a business owner to sell their business to buyers in their community, and discusses costs and benefits, including taxes. Topics include:

- Asset or Share Sales – how a business is sold can make for a better exit for the owner
- Financing options that make the acquisition of a business more attractive to buyers, and creates opportunities for current owners to earn more after-tax dollars
- Inviting employees to be part of the solution

These items, when applied could result in:

- Tax savings
- A more successful exit for the seller
- A more successful and smoother transition for the buyer

The final sections demonstrate Exit to Community using two case studies, additional considerations and how to get started.

There are elements in this guide you may already be familiar with. Our hope is to connect existing knowledge to exit planning, and to further advisors' expertise when it comes to assessing the costs and benefits of Exit to Community. Exit to Community may not always be the best fit; however, we feel the strategies in this guide will broaden advisors' thinking about this issue and provide more options when it comes to achieving a successful exit.

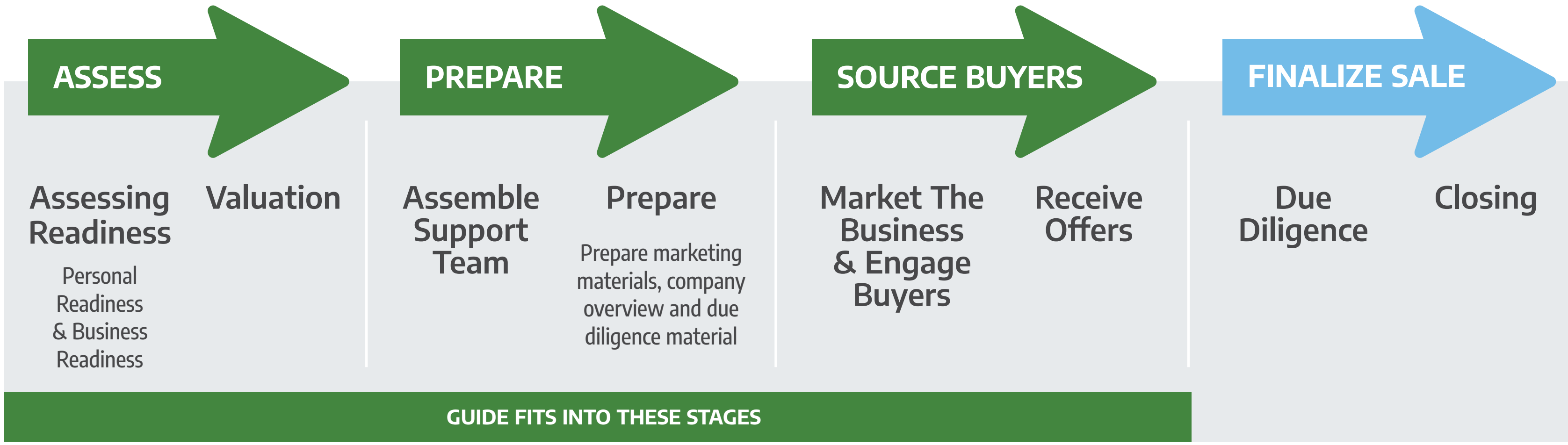
PART 1
Challenges and Opportunities in Selling a Small Business

This section reviews the process of selling a business. It assumes that some of the preparatory work has been completed. It is never too early to start the conversation on understanding the process. Regularly assessing the value of one's business is important for many reasons, not only in preparing it for a sale.

The Process of Selling a Business

There are several phases involved in the process of selling a business (See Figure 1). This guide is most applicable during the Prepare and Source Buyers phases.

FIGURE 1: EXIT & SALE PROCESS



This work is broadly described as **Exit planning**. It refers to the change in ownership with a current owner selling all, or some of the business. As Snider describes in Walking to Destiny, an exit plan asks and answers all the business, personal, financial, legal, and tax questions involved in transitioning a privately held business. Exit planning is achieved through developing a business transition plan that addresses 1) maximizing the value of the business, 2) ensuring the owner is personally and financially prepared and 3) ensuring the post-exit life is planned.[1] "Exit planning combines the plan, concept, effort, and process into a clear, simple strategy to build a business that is transferable through strong human, structural, customer, and social capital."[2]

Often included within the conversation is the similar process of **Succession Planning**. **Succession Planning** refers to planning for a change in leadership within an organization. As a business scales up, the owner-managed enterprise may hire a successor to lead the organization, i.e. a general manager or CEO. This individual may or may not have an ownership interest. Business owners often refer to this stage as becoming "hands off."

Every business is as unique as the personal situation of each business owner. As summarized in Figure 2, on the next page, there are several factors that impact exit options and the exit plan including tax consequences, enterprise value, bankability, personal situations of both buyers and sellers, importance of the business to the community (service, jobs, economic impact) and the ability of the owner to transition over time.

FIGURE 2: DEAL CONSIDERATIONS

Seller Characteristics

- Taxes
- Value Expectations
- Health
- Age
- Net Worth
- Family
- Push/Pull Factors

Business Characteristics

- Bankability
- Size
- Profitability
- Tangible Assets
- Intangible Assets
  - Human Capital
  - Customer Capital
  - Structural Capital
  - Social Capital
- Liabilities
  - Current
  - Long-term
  - Leases
- Economic Impact
- Business Value Drivers

Buyer Characteristics

- Cash Available
- Credit Score
- Net Worth / Balance Sheet Strength
- Internal / External Buyer
- Investment Criteria
- Value to Community

Deal Characteristics

- Asset / Shares / Hybrid
- Vendor Financing
- Transition Time
- Lender Requirements
- Earnout
- Consulting Contract

These considerations are important regardless of the status of the buyer: individual, group, existing company, partnership, co-operative, not-for-profit or charity. Additional considerations include transaction fees such as business broker success fees, chartered business valuator fees, legal fees, accounting fees, and fees paid to registry agents. Other costs that might get missed are for the time and effort for all parties, in the due diligence process and to satisfy regulatory and/or lender requirements and disclosures. In many cases, with an internal sale (to family, management, or employees), a business broker is not involved and the success fee which may be as high as 12% can be avoided.

In the years leading up to an exit (4 - 5 years), it is advisable for a business owner to assess readiness for new leadership (a successor) and for their own exit (personal readiness to exit and business readiness to exit). The time is ripe to begin the preparation phase before engaging with buyers.

Part of the preparation phase includes assembling and meeting with advisors. Meeting with their accountant or tax lawyer early in the process can provide insights into the tax implications under different exit options. Meeting with specialists for tax planning can be a short-term relationship, specific to the challenge at hand without requiring their expertise on an annual basis. When business owners are clear about the tax implications under different scenarios, they are better able to negotiate a successful deal, understanding that in some cases, accepting a lower price can result in more after-tax proceeds.

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As the business owner enters the Prepare Phase, they may face some costs. This can range from zero incremental cost, as the work could be incorporated into the annual year-end work accountants and legal advisors are already doing with their clients, to $10,000 or more if they are doing estate freezes, needing to amend articles of incorporation, catching up on minute books or dealing with land (real estate legal fees and/or land title fees). Further, if they need to set up another company, the costs include incorporation plus legal / advisor professional fees plus the work to roll any assets from one company into another. If they need to have assets appraised, that adds to the cost. Advanced planning can aid in managing costs over time. These costs can be considered an investment which will provide a big return in the long run.

As this guide is intended to support the ongoing legacy of a business, it is important for business owners to consider not only how they will exit the business, but also how the succeeding owners assume the owner role, ensuring successful continuity of the business. These concepts will be revisited in the case studies, especially when considering:

- Tax implications in different scenarios - all business transitions are not taxed in the same manner
- Financing can be an issue, especially if there are not a lot of buyers and there is value in intangible assets
- Costs of selling a business (time and money) will influence whether the owner sells, or closes the door

Considerations

Every business exit is unique and will depend on several factors. These factors contribute to what is known as the **Deal Structure**, which describe the terms of the agreement between a buyer and a seller. The deal structure includes the price, the timing of payments, conditions associated with the payments and other terms that may be negotiated. Valuation, financing, and the broader tax implications to the seller are some of the key elements that go into the deal structure. This section explores how these elements could be used to facilitate Exit to Community.

Ideally, a seller would like the buyer to be solely responsible for financing the purchase; however, that's not always possible or desirable for the buyer. Lenders assess the "bankability" of the business using criteria that varies from institution to institution. **Bankability** refers to the ability of the business to attract the interest of lenders. A bankable business has sufficient assets, profits, cash (liquidity) and collateral.

Financing is often "stacked" or structured as follows:

1. Cash from buyer - down payment paid to seller to "secure" the deal and paid on closing
2. Financing from bank - per bank's assessment of bankability paid to seller on closing
3. Vendor Financing - fills the gap to get to minimum valuation - paid to seller over time
4. Royalty / Earn out – paid to seller if conditions are met until termination clause met (time / cap)

Figure 3, below, illustrates the connections between bankability and deal structure. Whether the sale is structured as an asset sale, a share sale or a combination in a hybrid sale, the net after-tax proceeds will differ. Sellers may also continue to be involved post-closing in several ways for reasons discussed later in this guide. The roles the seller is willing to assume are often part of the deal structure and designed in ways to mitigate risks for the buyers (i.e. continuity and transition with customers), overcome financing gaps or provide an opportunity to realize a higher valuation. A common role for sellers to play is that of lender (vendor financing).

FIGURE 3: DEAL STRUCTURE

Bankability

- Assets
- Profit
- Cash
- Collateral
- Strength of Management
- Credit Rating
- Business Plan
- Guarantees
- Quality of Financials

Asset/Share/Hybrid

Asset Sale
Tax on recaptured capital cost allowance, capital gains and goodwill
Best for future tax writeoffs for buyer

Share Sale
Tax on Capital Gain
Ability to claim reserve to defer tax
Most preferential tax treatment to seller

Hybrid
Sell assets & then sell shares

Vendor's Role

- Promissory Note
- Take Back Clause
- Earnout
- Consultant
- Employee

The Challenge

Most business owners are unprepared for succession and their business is likely not ready for them to exit. Therefore, succession and exit conversations are relevant and important with all owners. The problem is most urgent with retiring business owners. When not prepared for an exit, their retirement is impacted from a financial perspective and can affect mental health and wellbeing. Financially, if the business owner has insufficient investments outside the business, they will continue to depend on the profits from the business to fund their personal expenses. As a result, they continue to work long past traditional retirement age, often with decreasing effort to grow and improve the business. From a mental health perspective, the increased stress when faced with feeling their financial future and their legacy are at risk, compounds the problem.

This becomes a larger issue in our economy as there are large numbers of business owners nearing retirement age, not to mention the impacts of a global pandemic. A recent article in the Globe & Mail identifies some disturbing findings about the impact of COVID 19 on small businesses:

1. Disproportionately impacted with major changes in all aspects of their business
2. Continued uncertainty, coupled with immediate impacts, may lead to forced closures or unsustainable amounts of debt
3. Canadian Federation of Independent Businesses (CFIB) estimates that more than 239,000 businesses could close permanently due to COVID-19 restrictions and lockdowns[3]

Further, experts who research exit planning of small businesses observe that most businesses 1) do not have a plan, and 2) most businesses will not be sold. Given that small businesses play an important role in our economy, the loss of these businesses could have a significant impact; especially when it comes to employment trends. Without an exit plan and if they are facing financial or other pressures, an owner may sell their business under duress. This means they:

- may get less for their business
- feel forced to lay-off employees
- are more exposed to unnecessary taxes, and
- miss out on the benefits of selling their business at its highest value

However, all is not lost. There is a generation of younger entrepreneurs looking for an opportunity to own a business and be "masters of their own destiny." These new buyers want to see small businesses continue to thrive. Employees can also have strong interest in taking over the business, but may be unaware of how this can be achieved with their limited funds. Crowdfunding has introduced many individuals to the opportunity to be a financial ally for businesses. Crowdfunding equity has specifically provided the opportunity for local investors to have fractional ownership. The next section explores how funding is realized through a co-op model for both individuals seeking to buy a local business and employee ownership solutions.

Local Solutions to Business Exit Challenges

In Exit to Community: A Community Primer,[4] an **Exit to Community** is defined as a strategy that connects founders, workers, users, investors, and friends in developing a long-term asset for the community, co-governed by members. An Exit to Community expands the potential buyer pool by including the potential of employee ownership and local / regional investors. Exit to Community may also change the purpose of the business from being solely profit driven to include social purposes, important to Millennials and Generation X.

Although there are many ways for communities to play a role in acquiring a business, this guide focuses on two specific types of Exits to Community: selling the business to an Opportunity Development Co-operative (ODC) and converting to employee ownership. Refer to Appendix 1 for more detailed descriptions.

Opportunity Development Co-operatives or ODCs are for-profit co-operatives that raise and deploy private capital through the sale of exempt market shares that are RRSP and TFSA[5] eligible. They are typically led by a volunteer board of directors made up of member-investors. ODCs invest in local businesses to create a financial return to their members, as well as create broader economic development impacts, such as great jobs and business retention in rural communities. ODCs can play a role in Exit to Community in many ways. They can invest in the company by purchasing shares (equity investment), by loaning funds (debt investment), or a combination of both. They may also partake in purchasing real-estate and land or acquire a business outright. In terms of acquiring a business an ODC could hire a manager or CEO to replace an exiting owner, or work with existing staff. Further, the ODC may play a role as a strategic advisor to help a business through the transition phase. In this regard the ODC becomes the new owner, similar to a small private equity firm owning a business. Some of the benefits of connecting with an ODC for a succession solution include:

- Shared Legacy Goals
  - Business continuity means jobs are protected
  - Local supply chains and procurement options are not disrupted
- Flexible Financing
  - ODCs offer a range of financing options for local entrepreneurs
  - Have the ability to structure repayment or loans based on revenue or other benchmarks, allowing for new businesses to get started without high monthly payments
- ODCs can take a second position, making it easier for other lenders to provide financing

Another benefit of an ODC is inclusion of a group of local citizen-investors who value the long-term success of a local business. Investor members of an ODC often support the business as customers, and the board of an ODC may provide strategic insight to the new owners for long-term success.

When forming an ODC, it is essential to develop expertise in board governance, enlist legal expertise to incorporate a co-operative and to ensure securities compliance. This adds to the setup and transaction costs for the ODC.

Employee Ownership. Selling a business to employees offers a tremendous amount of value to a business owner. The Employee Ownership Expansion Network[6] identifies the following benefits to employee ownership:

- Preserving jobs and community impacts – keeping jobs in the communities where they are rather than moving or losing them.
- Helping companies attract and retain good employees – Employee-owned firms with engaged cultures have higher retention rates.
- Improving company performance - Studies have shown[7] that employee-owned firms tend to out-perform comparable companies, while exhibiting more resilience during economic downturns.
- Improving wages and benefits – Employee-owned companies tend to have higher wages and better benefits.
- Enabling employees to build wealth over time – Once the selling shareholder and associated loans are paid off, future profits can be retained in the business, growing its equity and corresponding value in the employees' wealth.

Employee ownership offers a viable solution as employees usually understand the business operations and may only require mentoring and coaching from the exiting owner or a mentor. This coaching/mentoring supports knowledge transfer to successors (often younger people), who also benefit by developing their business competencies and leadership skills.

Employee ownership is a practical solution to the problem of business succession. It can be realized utilizing a worker co-operative, a direct sale of founder's shares to employee(s) (one-time event or on an annual basis) or by issuing new treasury shares, which dilutes the founder's equity.

The two structures that facilitate employee ownership include:

- **Employee Stock Equity Plans (ESOPs)** allow employees to acquire ownership in a company, heightening employee buy-in and investment, while fostering accountability and an ownership mentality. They may include stock options, stock purchase, phantom-stock ownership or a combination of these alternatives. Employee ownership can range from 1% to 100% of the company. As employees become owners, they share in the risks and rewards of the company.[8]
- **Worker Co-operatives:** Worker co-operatives are businesses that are owned and democratically controlled by the members. The main purpose of a worker co-operative is to provide employment for its members through operating an enterprise that follows the Co-operative Principles and Values.[9]

Employees, however, may require support to take the deal to closing. They may be unfamiliar with the myriad of responsibilities that come with being an owner. If employees do not have a strong understanding of business principles, such as financing requirements for the business, support and training will be necessary. Also, their own financial capacity may limit their ability to participate. These may slow the exit planning process, and depending on their capacity, could stall or eliminate this alternative.

Part 1 Endnotes

1. Snider, C., (2016), Walking to Destiny: 11 Actions an Owner Must take to Rapidly Grow Value & Unlock Wealth. Think Tank Publishing House

2. Snider, Pg. 46

3. CFIB Raises Forecast of how many Small Businesses may Vanish. https://www.theglobeandmail.com/business/article-cfib-raises-forecast-of-how-many-small-businesses-may-vanish

4. Alleyne, M, Canon, C, Evans, A, Feng, Y, Schneider, N, Zepeda, M., (2020), Exit to Community: A Community Primer, Retrieved April 12, 2021 from https://www.colorado.edu/lab/medlab/sites/default/files/attached-files/exittocommunityprimer-web.pdf

5. When dealing with exempt market shares it is imperative you consult your provincial securities commission and enlist the services of lawyers and accountants experienced in securities and tax law.

6. Employee Ownership Expansion Network. (2021).Employee Ownership 101: You might not have considered all the options. Retrieved May 24, 2021 from https://eoxnetwork.org/eo101/

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PART 2
Enabling Factors for Exit to Community

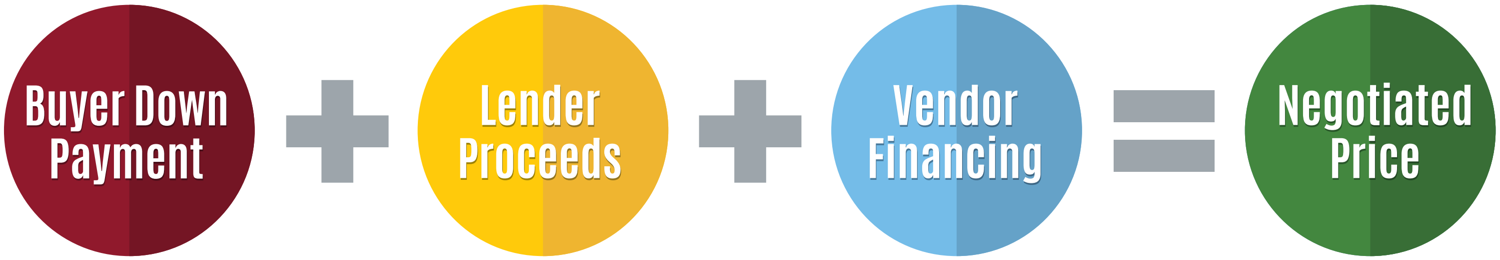
To increase the likelihood of Exit to Community this section explores two strategies that are often overlooked when it comes to discussing the exit of a business. These strategies are based on maintaining the legacy of the business, and in many ways makes the business owner a key player, and beneficiary of this work.

The first strategy focuses on how business owners can make the financing for prospective buyers more favorable, as well as create scenarios where the value of the business could increase, providing a bigger payment to the business owner when they exit. The second strategy looks at how a business is sold and explains how a share versus an asset sale could benefit both buyers and sellers. These elements are reflected in the case studies in the next section.

Seller Taking Payment over Time (Vendor Financing)

When considering an internal sale to management, employees, or family, vendor financing is a tool that can be used to bridge the gap between what the individuals can finance, what the bank will lend, and what the seller is willing to accept. In other words:

FIGURE 4: STACKED FINANCING



When selling a smaller business, it is common that the buyer would get a bank loan and then ask the seller to finance part of the sale. The seller agrees to take some money in future payments. This agreement is documented by a lawyer in the form of a Promissory Note, commonly referred to as a Vendor Take Back (VTB). Many of these VTB agreements include a "take back" clause allowing the seller to take the business back if the buyer is not successfully sustaining the operation. Because vendor financing is almost always secondary to a lender, it may carry a higher interest rate, may restrict dividend payments, may allow the vendor a seat on the Board, or other conditions until the note has been repaid. Vendor Financing is extremely common with "Main Street" or "Mom and Pop" businesses - those most found in rural communities.

Benefits to Buyers[1]

1. **Patient Capital** – Vendor financing terms are highly dependent on the parties involved in the deal. It may attract a higher interest rate when buyers are not known to the sellers. Alternatively, in situations when the parties are family members or long-time employees, interest rates may be lower. Vendor financing may offer deferred principal repayment, or a balloon payment of principal and interest at some future date. It is unsecured.

2. **Risk Mitigation** - Vendor financing is an excellent mechanism for the buyer to recover surprise costs or liabilities that were not disclosed before the transaction closed. Although it has no impact on the negotiated selling price, the terms of the deal may allow adjustments to be netted against future payments to sellers.

3. **Ties Seller/Vendor** - Vendor financing keeps the seller engaged throughout the crucial transition period. This is especially important if the buyer has no experience running a business in the industry. The seller's participation helps the buyer understand how the industry works, which allows the buyer time to document processes and gain the information needed to effectively run the company. It encourages the seller to transition knowledge and relationships to the new owners. It also allows the seller to ease out over time, semi-retire and build interests outside the business.

4. **Closing the Deal** – Researchers from Pepperdine University[2] found that deals collapse for many reasons – approximately 10% of the time from lack of capital to finance. When sellers agree to be part of the financing package, they increase the probability that they will achieve a negotiated sale of their business. Banks are often reluctant to lend against intangible assets such as goodwill or intellectual property; for that reason, Vendor Financing can sometimes be the difference between selling or not.

Benefits to Sellers

Although an all cash deal would be preferred for many sellers, vendor financing can offer an upside to sellers:

1. **Cash Flow** - A revenue stream will continue to flow to the seller over the vendor financing term. If the buyer defaults on the loan, the seller can repossess the business (a vendor take back) or sell assets to satisfy the debt. Collecting interest over the term of the loan adds to the cash flow. Although you are no longer running the company, you continue to have an annuity stream.

2. **Negotiation Strength** – The seller has greater control of the negotiations and can often obtain a higher selling price when the buyer is unable to access financing from outside lenders.

   a. It provides a signal to the buyers that the seller is confident the business will continue to be successful and thus is worth the goodwill

   b. It provides the opportunity for sellers to realize the high end of the valuation if a royalty or earnout is structured into the future payments

   c. It brings more potential buyers to the table which may increase the sale price

Seller Taking a Royalty on Future Results (The Earnout)

In some situations, the seller may be asked to stay on in a leadership role (with specific conditions) and earn additional payments based on achieving goals, often revenue or profit targets. Other targets may include retention of customers or key employees. This tactic may allow the seller to realize additional proceeds from the sale of the business over and above the negotiated purchase price. It is a strategic alternative for situations where the business is dependent on the owner, is a start up without a proven earnings record, and is often used with a service-based business. Earnouts generally have a term associated with them and/or an earnings cap. The agreement ends when the conditions are met.

Earnouts support succession by bridging the gap between asking price and offer. As an alternative to an earnout, the seller may be asked to stay on under an employment contract or as a consultant on a fee for service basis.

Caution! Earnouts can be problematic for several reasons. Firstly, the seller may not be granted the ability to make business decisions which would allow them to hit the targets in the agreement. The seller may not be emotionally ready or able to be "the employee." The new boss has little incentive to support the seller in achieving those goals if that means they have to pay more. **Earnouts are not guaranteed.**

Asset or Share Sale

The sale of an incorporated business can be structured in 2 ways: an asset sale or a share sale. In an asset sale, the assets of the business are sold. Typically, only the operating assets are sold with other assets remaining in the company, at least temporarily. The company continues with the same shareholders until it is wound up. The buyer operates the business using a structure of their choosing (i.e. sole proprietor, partnership, private company, etc.). In the case of a share sale, the shareholders of the operating company sell their shares to the buyer and the company continues under new ownership. A discussion of each option is found in this section

Asset Sale

When considering an asset sale, there are two potential levels of tax:

1. Tax paid by the corporation as a result of the sale of assets and
2. Tax paid by the vendor personally as the proceeds are taken out of the company.

In an asset sale, the buyer and the seller must agree on how the purchase price will be allocated to the assets sold. The buyer will want to allocate as much as possible among inventory or depreciable property to minimize future taxable income. The seller will want to ensure that the allocation minimized recapture of any capital cost allowance (explained below) or a realization of income on the sale of inventory. The purchase agreements should specify the allocation and require both parties to file their tax returns in a consistent manner.

The tax values of these assets will be used to determine the income for tax purposes. Taxable income with an asset sale occurs in the following situations:

1. **Recaptured Capital Cost Allowance** - Tangible assets such as furniture, vehicles, equipment, leasehold improvements, buildings, and fixtures may have been amortized in the accounting records for tax purposes, the difference between asset's value (lower of original cost or sale value/ FMV) to the tax value will be included in income. This is a "recapture" of the Capital Cost Allowance that has been deducted over the years.
2. **Capital Gains** - If a capital asset is sold for more than its original cost, a capital gain will result. This is often the case for real estate that tends to appreciate over time. Shares of privately held companies that change hands may also trigger a capital gain. Although not impossible, it is rare for equipment, vehicles, furniture, and other types of tangible assets to appreciate over time. A portion of the capital gain is taxable (currently 50%), though this tax may be deferred in certain circumstances when the sale proceeds are paid over time.

3. **Goodwill and Intangible assets** - These are assets that might not even be carried on the books as the investments in these assets occurred over time and were expensed. These assets have been developed over time rather than purchased on the open market. Snider[3] describes these 4 C assets as 1) Social Capital (i.e. reputation, culture, brand), 2) Human Capital (i.e. a productive and engaged team), 3) Structural Capital (i.e. processes and systems) and 4) Customer Capital (i.e. loyal, repeat customers). When assets are sold, the purchase price will be allocated to the tangible assets first, then to the identifiable intangible assets such as intellectual property, and any remainder will be considered goodwill. **For the seller,** goodwill is currently included in income (as income from property) at the capital gains inclusion rate (50%). Although taxed at the 50% inclusion rate, goodwill is not a capital asset eligible for the capital gains exemption or the deferrals allowed if proceeds are received over time.[4] The non-taxable portion accumulates in the corporation's Capital Dividend Account (CDA) allowing it to be distributed tax free to the shareholders. **For buyers** of goodwill, the purchase price of goodwill is included in a Class 14.1 of the Capital Cost Allowance system.

An asset sale is often the most expensive option for a seller. Higher taxes can be offset with higher sale prices as the seller is most likely to negotiate a purchase price on the higher end of the valuation range to maximize their after-tax proceeds. However, the buyer may benefit from higher asset values to amortize against future income, and correspondingly higher deductions for tax purposes. If the buyer insists on an asset sale, it is important for the seller to consult their tax advisor to calculate the after-tax proceeds compared to a share sale.

Why Sell Assets?

- Keep your company going with the ability to withdraw cash over time with dividends or salary and thus defer additional tax until cash is taken out of the corporation
- May want to use the corporation for new ventures which may benefit from tax losses if available
- May have other business units operating from same company
- May have some assets that are not for sale - i.e. sell business but not the real estate
- Don't want to undergo the time and cost to restructure if necessary
- Seller often retains responsibility for receivables and payables, including bank loans
- Company does not or cannot meet conditions for a Qualifying Small Business Corporation (QSBC). In this case, the gain on the sale of shares does not benefit from the Capital Gains Exemption.

Considerations for a Share Sale

In most cases, the sale of shares is preferred by sellers as the availability of the Lifetime Capital Gains Exemption (LCGE) for QSBC shares allows for the first $892,218[5] in capital gains to avoid tax, thus netting improved after tax funds to the sellers. Even if the shares do not qualify or the LCGE has already been used, the tax on capital gains on a share sale will be lower than on an asset sale. There are, however, other factors to consider including the utilization of loss pools and the ability to defer personal taxes in prior years.

Why Sell Shares?

- No need to wind up the company after sale incurring additional accounting and legal fees to do so
- Clean exit – seller simply walks away[6]
- Lifetime Capital Gains Exemption can be used to maximize after-tax proceeds

What do Buyers Prefer?

Many advisors caution buyers about the risks of buying shares. Those risks are primarily associated with the future liabilities of the company. Most concerning are Canada Revenue assessments (income tax, payroll tax or excise/gst), employee liability, and product liability. Lawsuits can be scary; however, there are tools and tactics available to help mitigate these risks both through the deal structure, due diligence process, and with warrants or insurance products.

Additionally, any receivables, inventories, trade accounts payable, loans or other liabilities need to be addressed through the due diligence process, to ensure they are complete, legitimate and adjusted where necessary. The term sheet may require the company to repay or settle any loans or receivables to related parties. Similarly, any loans personally guaranteed by the sellers would need to be addressed through the due diligence and closing process.

Canada Revenue Agency can reassess returns for 6 years after the notice of assessment, or due date of the return, whichever is later. Potential "off the books" liabilities may need to be addressed. For example, claims from former employees related to their employment. This period may be extended indefinitely in cases of fraud. If the deal is structured with payments over time, future payments can be offset by any payments associated with these risks, coupled with clauses in the purchase agreement laying out the responsibilities for these potential liabilities. When share purchases are contemplated, reviews or audits may be required from the buyer to provide further assurance or confidence that the financial information supplied by the seller is reliable.

The advantage of buying shares includes the ease of transferring ownership of the shares rather than multiple assets in an asset sale. The buyer may also be able to negotiate a purchase price on the lower end of the valuation range given the preferred tax consequences of a capital gain to the seller. In order for the interest to be deductible, the specific conditions of ITA 20(1)(c) must be met. Among other specific requirements is the requirement that the purpose of the use of the money must be to earn income. In the cases of a common share purchase, CRA generally considers the interest "deductible on the basis that at the time the shares are acquired there is a reasonable expectation that the common shareholder will receive dividends"[7]

The disadvantage of buying shares include the inability to "bump up" the cost of the tangible assets to their fair market values and being able to record the goodwill purchased on the books. Thus, future write offs, both for accounting purposes and tax purposes will be lower under a share purchase than under an asset purchase.

Hybrid Alternative

In certain circumstances, such as when the sale price will exceed the LCGE limit, it may be preferable to structure a deal involving the sale of both assets and shares. There is significant complexity involved in such transactions requiring consultations with legal and tax advisors if a seller wanted to explore this option further. The hybrid would allow the buyer to benefit from the "bump up" in costs and also allows the seller to benefit from the lifetime capital gains exemption.

Appendix 2 contains a summary of the pros and cons of an asset and share sale from both buyer and seller perspectives.

Seller's Role Post-Sale

When negotiating deal terms, the buyer may want the seller to play a role after selling the company. According to Warrillow,[8] there are many different ways to structure the seller's role after the sale. Sellers may be asked to play any one or more of these most common roles:

- Lender – Vendor Takeback or VTB
- Division Executive – Earnout
- Consultant – Contract/Fee
- Shareholder – Recapitalization

The more flexible and open the seller is to all deal structures, the better able to negotiate the role post exit. Being too rigid or appearing unwilling to help the buyer can turn off a lot of buyers and undermine the seller's negotiating leverage.

Part 2 Endnotes

1. BDC. (2021). How Vendor Financing can help your acquisition. Retrieve May 17, 2021 from https://www.bdc.ca/en/articles-tools/start-buy-business/buy-business/how-vendor-financing-can-help-your-acquisition

2. Everret, Dr. C., (2017). Private Capital Markets Report 2017, Pepperdine Graziadio School of Business Management

3. Snider, C., (2016), Walking to Destiny: 11 Actions an Owner Must take to Rapidly Grow Value & Unlock Wealth. Think Tank Publishing House

4. Rotfleisch, & Samulovitch Professional Corporation. (2020). Retrieved May 24, 2021 from Taxpage.com. https://taxpage.com/articles-and-tips/changes-to-the-capital-property-tax-rules-2/

5. This is the amount of the Lifetime Capital Gains Exemption in 2020. It is adjusted for inflation and indexed each year.

6. Regardless of the type of sale, there is always the possibility of lawsuits

7. Canada Revenue Agency, Income Tax Folio S3-F6-C, Interest Deductibility Retrieved May 17, 2021 from https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-3-property-investments-savings-plans/series-3-property-investments-savings-plan-folio-6-interest/income-tax-folio-s3-f6-c1-interest-deductibility.html#toc39

8. Warrillow, John. (2021). The Art of Selling Your Business. Built To Sell, Inc.

Case Studies

Note: Given the complexities of income tax in any situation, the case studies have been created for illustrative purposes only. Owners are strongly encouraged to meet with their accountants and tax advisors early in the process to assess their specific tax consequences.

CRA CAUTION

Should CRA choose to object to the valuation, Jen and Paul should have a valuation of the business completed by a Chartered Business Valuator (CBV) so they are able to justify the valuation should CRA reassess the transaction. CBV fees vary depending on the complexities of the business. Jen and Paul should budget at least $7,500 for a CBV. Challenges tend to occur in the context of family transactions or tax-free rollovers. When independent 3rd parties are involved, there are fewer CRA challenges.

Abattoir

Jen and Paul live in a small town (less than 2,500 residents). The economy in the area is agriculture – primarily the production of crops, beef, and hogs. Jen and Paul established the abattoir in 1995. It now has 14 people employed in production, shipping/receiving, retail and support roles. Jen and Paul continue to work as general managers, are responsible for new business development, and are actively involved in industry events and local organizations. The abattoir has been profitable. In addition to taking small salaries, dividends from the business have provided cash to invest outside the business. This is available to them to partly fund their retirement. The business has been valued at $425,000 - $500,000 with much of the value related to the business's long-standing reputation and ongoing customer contracts. None of Jen and Paul's three children are interested in taking over the family business. They have permanently moved to the city.

Utilizing the Exit Option Checklist (Appendix 3), the business owners and their advisors decide the most likely exit options are:

1. **Sale to workforce**
2. **Sale to a worker co-operative**
3. **Sale to a 3rd party**

As an abattoir, it has been challenging to hire the talent needed to grow the business, however, the team has gelled and turnover is relatively low. Two of the production floor employees have been with the company for 6 and 10 years, respectively. Establishing team leaders and supervisors has lessened the day-to-day operational demands on Jen and Paul. The owners are concerned about the fit of their replacement with the existing team. They would prefer to sell the business to their employees, who are like family to them. They do not know how to make that happen. If a sale to employees is not an option, they will go to market in search of a 3rd party buyer. They have come to their business advisor for advice.

Asset Share vs Share Sale

Demonstrating to Jen and Paul the after-tax cash available through a share sale, the advisor provides them with information so they can structure the deal in a way that indeed makes employee ownership possible.[1] If the shares of the abattoir qualify for the capital gains exemption, the sale of the shares can be accomplished on a tax-free basis. Assuming this is the case, the after-tax cash would be the agreed purchase price of the business. The differential tax treatment of capital gains makes it attractive for Jen and Paul to sell shares of the business vs the assets, even if the sale price is at the lower end of the valuation range. A lower purchase price will favourably impact employee ownership. Some lenders may require vendors to defer their payments until the lender has been fully repaid.[2] Assuming a 5-year term loan to the lender, that would mean Jen & Paul would receive the majority of their funds on closing from the bank financing and the employee down payments. The remaining vendor financing payments would begin 4-5 years after the sale, when the lender's loan has been substantially repaid.

There are two levels of tax with an asset sale.

- Tax paid by the corporation on the sale of assets and
- Tax paid personally by the seller when the net proceeds are withdrawn from the company

After tax proceeds to Jen and Paul are $352,809.69. Please refer to Appendix 4 for full calculations.

The Next Decade for Jen and Paul

Table 1 below outlines a potential scenario of how the next decade could roll out for Jen and Paul. **Numbers are for illustrative purposes only. Each situation is unique and after-tax proceeds must be calculated for the specific circumstances.**

Assumptions:

TABLE 1: ABATTOIR ASSUMPTIONS		Interest	Interest only (Annual)	Principal + Interest (Monthly)
Sale Price	$475,000			
Cash on Closing:				
From the Bank loan – 50%	$237,500	10%		$4,746.36
From the Down Payment – 25%[3]	$118,750			
Vendor Financing – 25% - Paid to Jen and Paul	$118,750	8%	$9,500	$2,407.82

1. Net cash from sale invested at 6%. Income withdrawn each year to fund retirement to approximately $60,000
2. Seller receives interest only payments for 4 years, simple interest calculated for illustrative purposes
3. Vendor financing principal & interest commences in year 5 (final year of bank loan)
4. Have not factored in tax on personally received dividends or interest on an annual basis

Tables 2 and 3 below demonstrate two scenarios for the next decade of cash flows related to the transaction, financing and investing activities that could be undertaken. In this example, we've assumed an annual income (cash) requirement for Jen & Paul is approximately $60,000. We have not factored in other income or assets that may be available to the couple to fund their retirement.

TABLE 2: PRE-TAX CASH FLOW - ASSET SALE

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Salary/Dividend	$60,000	$60,000									$120,000
											$-
Cash on Closing		$356,250									$356,250
Income Tax (See Appendix 4)		-$122,190									-$122,190
Invested net proceeds from sale		**$234,060**									**$234,060**
Interest from Vendor Financing			$9,500	$9,500	$9,500	$9,500					$38,000
Cash Withdrawn from investment			$35,000	$35,000	$40,000	$45,000	$25,000	$30,000	$24,060	$-	$234,060
Principal & Interest Vendor Financing							$28,894	$28,894	$28,894	$28,894	$115,576
Investment Income			$14,044	$11,944	$9,844	$7,444	$4,744	$3,244	$1,444	-$0	$52,705
Total Cash (pre-tax)	**$60,000**	**$528,119**	**$58,544**	**$56,444**	**$59,344**	**$61,944**	**$58,638**	**$62,138**	**$54,398**	**$28,894**	**$1,028,460**

Investment Account - Beginning	$-	$-	$234,060	$199,060	$164,060	$124,060	$79,060	$54,060	$24,060	-$ 0	
Deposit / Withdrawal	$-	$234,060	-$35,000	-$35,000	-$40,000	-$45,000	-$25,000	-$30,000	-$24,060	$-	-$0
Investment Account - End	$-	$234,060	$199,060	$164,060	$124,060	$79,060	$54,060	$24,060	-$0	-$0	

Interest @ 6%			$14,044	$11,944	$9,844	$7,444	$4,744	$3,244	$1,444	-$ 0	

TABLE 3: PRE-TAX CASH FLOW - SHARE SALE

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Salary/Dividend	$60,000	$60,000									$120,000
											$-
Cash on Closing		$356,250									$356,250
Income Tax (AMT may apply)											$-
Invested net proceeds from sale		**$356,250**									**$356,250**
Interest from Vendor Financing			$9,500	$9,500	$9,500	$9,500					$38,000
Cash Withdrawn from investment			$35,000	$35,000	$35,000	$35,000	$20,000	$20,000	$20,000	$20,000	$220,000
Principal & Interest Vendor Financing							$28,894	$28,894	$28,894	$28,894	$115,576
Investment Income			$21,375	$19,275	$17,175	$15,075	$12,975	$11,775	$10,575	$9,375	$117,600
Total Cash (pre-tax)	**$60,000**	**$416,250**	**$65,875**	**$63,775**	**$61,675**	**$59,575**	**$61,869**	**$60,669**	**$59,469**	**$58,269**	**$967,426**

Investment Account - Beginning	$-	$-	$356,250	$321,250	$286,250	$251,250	$216,250	$196,250	$176,250	$156,250	
Deposit / Withdrawal	$-	$356,250	-$35,000	-$35,000	-$35,000	-$35,000	-$20,000	-$20,000	-$20,000	-$20,000	$136,250
Investment Account - End	$-	$356,250	$321,250	$286,250	$251,250	$216,250	$196,250	$176,250	$156,250	$136,250	

Interest @ 6%			$21,375	$19,275	$17,175	$15,075	$12,975	$11,775	$10,575	$9,375	

The Next Decade Total Cash Comparison

Table 4 below summarizes the differences in the pre-tax cash flows under each scenario assuming the same price is negotiated in either an asset or share sale. It is not uncommon for the prices to be different under each scenario to account for differing tax consequences. The after-tax proceeds under either scenario factor into the cash available to invest which impacts the investment income as well as the annual draws to fund post- sale activities.

TABLE 4: COMPARISON SHARE SALE & ASSET SALE	Share Sale	Asset Sale	Difference
Salary / Dividend	$120,000	$120,000	$-
At Closing	$356,250	$234,060	$122,190
Interest on Vendor Financing	$38,000	$38,000	$-
Vendor Financing Principal + Interest	$115,576	$115,576	$-
Investment income on net proceeds invested	$117,600	$52,705	$64,895
Total	$747,426	$560,341	
Total Share Sale Advantage			$187,085

As this simple example demonstrates, there are significant tax savings to the seller (Jen and Paul) if the deal is structured as a share sale ($187,085). Should the seller accept an offer at the lower end of the valuation for a share sale, they can not only net higher after-tax proceeds when compared with an asset sale, but also make the acquisition more attractive to employees and reduce the cash flows required by these buyers to service the debt on the deal.

KEY MESSAGES:

- Encouraging clients to consider a share sale may significantly impact their net proceeds, thus enabling them to invest more funds to finance their post-exit lifestyle
- Financial institutions may require vendors to “go second” requiring them to defer principal repayments of their loans until the bank has been substantially repaid
- Advisors can support a client in addressing common buyer reservations associated with a share purchase such as potential liabilities, restructuring, cleansing the company[4] and / or removing assets that they do not want to sell with the business (i.e. real property)

Should the seller stay on in a consulting or employee role, additional income potential from salary or consulting fee is possible through the transition years.

Based on this information Jen and Paul decide to approach their employees to see if they are interested in buying the business from them. The following shows some of the options Jen and Paul could pursue. In these examples, we make a few assumptions:

- The lenders agree to lend 50% with 25% Vendor Financing and 25% contributed by employees.
- The lender will take the tangible assets as security (i.e. real estate, equipment, vehicles, machinery) and require personal guarantees from the employees (and often their spouses).[5]
- The lenders will likely require a General Security Agreement (GSA) extending their security to all assets.
- The employees have the financial capacity and enough confidence to pursue ownership of the business.[6]

Sale to Employees

Ideally, Jen and Paul would like to see their employees take over the company. They have developed the team over time and have confidence in their ability to grow the company as owners. Contrary to some of their counterparts, Jen and Paul are not worried about their employees running the business into the ground or making risky decisions. The team has close family ties, and strong relationships that can allow for working through conflicting perspectives. The following explores two examples of how Jen and Paul could facilitate the transition of ownership to the employees. The first is through a direct sale using a Unanimous Shareholder Agreement (USA), and the second is a Worker Co-operative.

Direct sale to Employees or Private Employee-owned Company

Depending on the financial capacity of employees, one (or more than one) employee could purchase the company. If it were more than one, they could have equal ownership if each employee contributed an equal investment. Or there could be a majority shareholder with other employees holding a minority interest.

Some employees may have competing goals and although buying the business might be nice, it plays second fiddle to buying a house or financing another large purchase. A direct sale to one or more employees is often a best fit when employees are already in a leadership / management position and there are a small number of employees. Although it might initially seem inclusive to have each employee with equal voting power (equal ownership), this may lead to major challenges in the future when decisions need to be made.

For clarity regarding decision making and future entry and exit of owners, a Unanimous Shareholders' Agreement (USA) is a critical document to create. The intent is that all shareholders are bound by, and subject to the USA, which is the rulebook for how communication and owner-related transactions occur.

Establishing an Employee Stock Ownership Plan (ESOP)

Alternatively, if Jen and Paul were willing to exit the company over time, an Employee Stock Ownership Plan (ESOP) can be established. This allows them the flexibility to leave the company on their own time and terms. If the company was set up with a small number of shares (i.e. 100 Class A shares), each share may be very expensive for an employee to buy. A simple stock split can be done which could result in, for example, 1 million shares. This effectively reduces the market value of each share to make them affordable for the employees.

Jen and Paul can sell their own shares to the employees over a period of a few, or many years. Typically, an ESOP is set up so there is an annual offering of shares to employees.

To ensure broad ownership, there is typically a restriction on how much of the company each employee can own. For example, the restriction could be that no individual employee can own more than 5% of the common shares.

With an ESOP, the employee-owners are subject to an ESOP Shareholders' Agreement, which is significantly different than a USA. It describes how employees buy shares, how they sell their shares, and a variety of other rules affecting ownership. The agreement is clear that the ESOP employees do not sit on the Board and are not involved in the strategic decision-making of the company.

The ESOP Shareholders' Agreement is superseded by a Unanimous Shareholders' Agreement, if one is in place.

Regardless of how the share transaction occurs, when Jen and Paul sell their own shares, they take the money from the sale. This allows them to exit in a tax preferred way where they may be able to utilize the Lifetime Capital Gains Exemption. Alternatively, the company could issue new shares from its treasury, effectively diluting Jen and Paul's interest in the company. When treasury shares are sold, the money stays in the company and can be used to grow the business without requiring Jen and Paul to sell their shares.

If the company were to buy back shares (redeem for cancellation) from Jen, Paul, or employees, a deemed dividend is triggered which is less tax-advantageous than selling to another shareholder or another third party.

Should a change in control take place, CRA requirements will impact accounting and legal fees during the year the change in control occurs. In essence, the company will need to create financial statements and file returns with CRA when the change of control occurs, effectively doubling the accounting fees in the year this happens.

Sale to a Worker Co-operative

Another option for the employees could be to form a worker co-operative. Some reasons for this could be:

- The cost of incorporation may be lower than establishing and administering an ESOP and the minimum requirement is three member-owners. A lower investment on due diligence may offset the investment in setting up the ESOP. The cost of incorporating a co-op will be higher than setting up a regular private company as it requires a specialist.
- Worker co-ops are based on a one-member one-vote governance structure. This works well for groups that want to share responsibility equally, have a great track record of working together and want to see the business have long-term success. The team may not be ready for collective decision making if the company has been run by management.
- The cost of a share in the company may be too expensive for an individual employee. A worker co-op may provide a structure that could raise the capital in a way that puts less burden on the individual employee.

This last point is likely a driving factor for many employees. The risk of being a business owner, counter-balanced with existing personal financial obligations, can make buying all or part of a business seem unattainable. A worker co-op structure provides a different share structure as well as an opportunity to, potentially, access other funds.

If the employees in this case study were to pursue purchasing the abattoir through a worker co-op, we might see a different scenario. For example, the fourteen employees could incorporate a worker co-op and follow this type of pathway:

- Cost of incorporation: $2,000.00
- Membership shares in the co-op: 14 employees at $5,000 each = $70,000
- Canadian Worker Co-operative Federation support
  - » $2,000.00 Technical Assistance Grant
  - » Tenacity Works Loan of $50,000.00

In this scenario the newly formed worker's co-op has $120,000.00 in combined equity and debt. They use this to secure a loan from the bank for $237,500.00.

Summary - Abattoir Example

Table 5 below outlines the assumptions and data for possible deal structures with different buyer groups. Note the ability of the worker co-operative option to access loan grants from co-operative lenders, thus effectively reducing the amount required from each employee.

TABLE 5: DEAL STRUCTURE - SHARE SALE	Sale to Workforce	Sale to Strategic Buyer	Sale to a worker co-operative	Sale to Individual
Purchase Price	$475,000	$475,000	$475,000	$475,000
Down Payment from Buyer (25%)	$118,750	$118,750	$70,000	$118,750
Loan & Grant - Canadian Worker Co-operative			$50,000	
Remainder	$356,250	$356,250	$355,000	$356,250
Bank Financing (50%)	$237,500	$237,500	$237,500	$237,500
Remainder	$118,750	$118,750	$117,500	$118,750
Vendor Financing (paid 2nd to Bank)[7]	$118,750	$118,750	$117,500	$118,750

When a sale to employees is contemplated, the number of buyers may exceed 1, thus spreading the 25% down payment amongst the employee ownership group. This may allow individual employees to secure financing through character loans, term loans secured with their home equity, or loans designed to support a specific group of individuals such as women, Indigenous individuals; or from groups such as the Worker Co-operative Federation. With 14 employees involved in either a direct acquisition or a worker co-operative, the 25% down payment of approximately $8,500 may be available from savings, loans from family/friends or a home equity loan.

Although debt service obligations will fall to the buyer, sellers are wise to consider the cash flow required to service debt when negotiating and during the Prepare phase. The Prepare Phase includes ensuring the business can service any debt that will be incurred on the transaction, which is included in projections that would be shared during the Due Diligence step in Finalizing the Sale phase. Sellers who assume they will receive full cash on closing are often disappointed. The buyers may not have the liquidity to close the deal without a financial partner. This additional debt servicing cost must be built into the plan because it can significantly affect the operating cash flows. Table 5 below outlines the annual debt service for financing from lenders including vendor financing.

TABLE 6: ANNUAL DEBT SERVICE REQUIREMENTS FROM CASH FLOW	Payment	Principal
Bank (assumed 10% interest & 5-year loan)	$56,950	$237,500
Vendor (assumed 10% interest & 3 yr amort. Principal payments deferred to yr 4)	$43,318	$118,500

Automotive Repair Shop

Hank grew up in the region and after completing his automotive mechanic journeyman certificate, he returned to his hometown and married his high school sweetheart. After working for a car dealership and commuting to the city for a few years (an hour away), he decided to open a local automotive repair shop. That was 20 years ago. With their children ready to leave the nest, Hank and his wife are thinking about retirement and what to do with the business. There are only a few competitors in the region. That said, there are many hobbyists who work out of their home-garages and many farmers who manage most of their maintenance tasks fairly well. Yet, Hank does not want to close the doors. People in the surrounding communities rely on his shop, as do the 6 employees and their families.

The business has been valued at $170,500, including $80,000 in equipment and supplies. Most of the income has been reinvested in the business but Hank has drawn a healthy paycheque for the past decade allowing him to have a nest egg set aside for retirement. That investment coupled with his wife's teaching pension will provide them with a comfortable retirement. Any proceeds from the sale of the business will help with the little extras and projects around the house. Hank is willing to stay involved in the business for a few years, if necessary, to mentor the new ownership and pass on his knowledge. He'd like the mentorship role to be part-time, giving him flexibility to explore his hobbies and enjoy more holiday time with his wife.

As was the case in the abattoir example above, there will be no tax on the capital gain if the transaction is structured as a share sale. If structured as an asset sale, there will be tax in the corporation on the recaptured capital cost allowance, if any, and the goodwill.

Utilizing the Exit Checklist (Appendix 3), Hank and his advisors decide that the most likely exit options are:

1. **Sale to workforce**
2. **Sale to 3rd party**
3. **Sale to an ODC**

However, Hank is concerned about selling to employees. In the past, he's found it difficult to recruit and retain quality employees. He has a tough time seeing any one of them stepping into a leadership role and being a suitable owner. A few of them are pretty green, with just a few years experience since school. Several have indicated their marriages are on the rocks, which could drastically affect their focus and financial capacity.

Selling to a 3rd party is a viable option. There are a few reputable shops within an hour's commute that may be interested in expanding their operations into a second location. However, Hank is concerned that they might buy his shop and close the doors. He is also concerned about a values fit, as they run their businesses very differently from Hank. It may be a clash of cultures, so to speak. He is also aware of his own mental baggage from high school days when he competed against those potential buyers in football and hockey. Past rivalries run deep.

Sale to Opportunity Development Co-operative

Hank's advisor mentioned the possibility of finding a group of local or regional investors (community citizens) who would be able to purchase the shop, potentially over time, especially if Hank is willing to be active in the transition period.

This might be a great alternative to consider, but Hank doesn't know what to do next. His advisor referred him to ACCA where he learned about Opportunity Development Co-operatives, or ODC (read more about an ODC in Appendix 1). Hank was happy to learn there was a group of people exploring an ODC in his town. More importantly, as someone who has been involved in his community, Hank knew a lot of people, including other business owners and accredited investors.[8]

After a few meetings with Hank, the ODC board members realized they could acquire the business, keep the existing staff working, and there would be no breaks in continuity. If needed, they could hire a manager.

The track-record of the shop demonstrated the investment could provide a return to the ODC: a dividend at least equal to the paycheque Hank was drawing from the business. To bolster the potential for long-term success, the ODC decided any returns for the first 2 years would be used to pay Hank as a contractor to facilitate the transition in management, and to reinvest in a few critical areas to grow the company. The ODC's expectations are that the business will have better margins in the third year, which will provide a great dividend to the member-investors. Future profits could result in opportunities to acquire other repair shops in the region.

Over the next three months,[9] the ODC was incorporated and an offering document was created to sell shares. A pool of local capital was collected to acquire Hank's business. The offer was structured as an 80% share sale on closing, with the final 20% equity purchased in 2 years when Hank plans to exit. As the ODC had a great board of directors and Hank had a strong reputation in his community, the funds raised for the ODC to acquire the business was completed within six weeks.

Summary - Automotive Shop, 2 Years Later

Hank continued to work in the shop, transitioning his knowledge to the newly hired manager, and together they implemented the new strategies suggested by the Board. Hank hadn't experienced the benefits of an Advisory Team before, and he noticed how quickly the business grew under the ODC's leadership. Through implementing a few strategic changes to increase efficiency and enhance business development practices, the shop quickly became more profitable. Hank felt good about leaving the shop in good hands and seeing the shop's value improve from $170,500 to $187,500 in 2 years. The ODC's 80% share was now valued at $150,000 or 10% ROI. Hank's 20% share now valued at $37,500.

APPRECIATION VALUE	
Deal Structure	**Sale to ODC**
Purchase Price	$170,500
80% purchase	$136,400
Value of Hank's retained 20% interest	$34,100
20% purchased in 2 years at FMV (Assumed)	$37,500

The Next Decade

Tables 7 outlines a potential scenario of how the next decade could roll out for Hank under the scenario outlines in the previous section. **Numbers are for illustrative purposes only. Each situation is unique and after-tax proceeds must be calculated for the specific circumstances.**

Detailed calculation can be found in Appendix 4 where the tax on a share sale is compared to taxes if the sale were structured as an asset sale.

TABLE 7: PRE-TAX CASH FLOW - SHARE SALE

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Dividend	$60,000	$12,000									$72,000
Consulting Fees		$50,000									$50,000
Cash on Closing (80% sale)	$136,400		$37,500								$173,900
Income Tax (Assumed 0 with LCGE)	$-		$-								$-
Income Tax	Tax on dividend, consulting fees and investment income										
Funds Withdrawn (invested)	-$136,400	-$10,000		$30,000	$30,000	$30,000	$30,000	$26,400	$-	$-	$-
Investment Income		$8,184	$8,784	$8,784	$6,984	$5,184	$3,384	$1,584	$-	$-	$42,888
											$-
Total Cash (pre-tax)	**$60,000**	**$60,184**	**$46,284**	**$38,784**	**$36,984**	**$35,184**	**$33,384**	**$27,984**	**$-**	**$-**	**$338,788**

Investment Account - Beginning	$-	$136,400	$146,400	$146,400	$116,400	$86,400	$56,400	$26,400	$-	$-	
Deposit / Withdrawal	$136,400	$10,000		-$30,000	-$30,000	-$30,000	-$30,000	-$26,400	$-	$-	$-
Investment Account - End	$136,400	$146,400	$146,400	$116,400	$86,400	$56,400	$26,400	$-	$-	$-	

Interest @ 6%		$8,184	$8,784	$8,784	$6,984	$5,184	$3,384	$1,584	$-	$-	

KEY MESSAGES:

- Encouraging business owners to consider a share sale can significantly impact their after-tax proceeds, enabling them more funds to finance their post-exit lifestyle.
- It is less likely to negotiate a staged sale if the sale were structured as an asset sale.
- If the business owner is willing to continue working through the transition years as an employee, or in a consulting role, additional income from a salary or consulting fees is possible.
- If an ODC is able to raise funds from accredited investors, there could be a reduction in outside financing requirements (i.e. institutional lenders) to close the sale. This could accelerate the timeline for the seller and reduce complexity by having fewer players involved.
- An ODC can invest in shares of the business. It can also provide loans. Or a combination can be used to invest in transitioning and/or growing local businesses.

Case Studies Endnotes

1. Alternatively, the sellers freeze some (or all) of the value in preferred shares, which allows the employees to buy at a much lower rate. They may not need bank financing. The preferred shares are paid back over time (with an agreement) and may have interest or dividends paid to make it advantageous to the sellers too. As the preferred shares are paid out, it allows the employees to greatly leverage the value increase.

2. Some lenders will not require deferral of the VTB if covenants are being met and payments won't put them offside. In these cases, VTB might be repaid first if they are short term and when they bear higher interest rates. Bank financing on building can be very long term. Alternatively, the bank loan may be renewed at expiry and those funds used to pay the seller.

3. Bank financing at 50% is used for illustrative purposes only. Banks tend to finance hard assets. In some cases, banks may be willing to finance more of the purchase price (see discussion on Bankability).

4. Cleaning refers to the process of removing some assets from the company, most often cash, that currently prevents the sale of the company's shares from meeting the definition of Qualifying Small Business Corporation in order to qualify for the Lifetime Capital Gains Exemption.

5. Personal guarantees will be joint and several, so better off employees will be more on the hook for this than the less better off ones. Joint and several liability allows the lender to recover from any or all of them.

6. This is not always the case; some employees will need support from an advisor in navigating the gauntlet put up by lenders. They may have experience dealing with consumer lending such as a car loan or a home mortgage, but many have no experience dealing with small business banking financial advisors. It is important to explore resources that can help build the capacity of the employees to confidently take-on an ownership role.

7. Warrilow, J. (2021). The Art of Selling your Business describes post-sale roles sellers can play in the business. These include 1) a lender offering vendor financing, 2) an executive with an earnout, 3) a consultant under contract, or 4) as a shareholder if recapitalization occurs. The deal terms can include one of more of these roles.

8. An accredited investor is an individual or a business entity that is allowed to trade securities that may not be registered with financial authorities. They satisfy at least one requirement regarding their income, net worth, asset size, governance status, or professional experience.

9. Depending on the capacity of the group, and the availability of qualified investors, ODCs can often take six months to a year to incorporate. For the sake of this example, we assume some initial work has been completed and the Automotive Repair Shop is in a good position to be acquired.

Additional Cost Considerations

Will there be expenses required to sell a business? Absolutely.

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The intent is that these costs will be recouped through earning a higher value from the business. Costs will vary depending on the type of sale and the amount of work that may be required to, say, get the business ready. Selling to employees or an ODC could create a situation where some of these costs can be avoided. For example, an internal exit (sale to employees or family members) can be negotiated with the assistance of a transaction advisor, which would avoid the success fee from a business broker. Advance planning and careful consideration is necessary to maximize benefit and minimize stress. It is always important to consult with an advisor, or several advisors on these matters.

Professional Fees - Accounting and legal costs will be incurred for all transactions by both the buyers and sellers.

Lawyers are involved in setting up:

- definitive purchase agreement
- vendor financing agreements, where applicable
- security agreements
- incorporation documentations / amendments
- representation documents, waivers and warranties
- non-competition agreements
- partnership agreements, Unanimous Shareholders' Agreements, ESOP Shareholders' Agreements
- offering memorandums.

The fees will vary depending on the complexity of the deal, the expertise required, and the ability of the parties to efficiently utilize their services. Some specialized services may not be available in every community. Accountants and lawyers work hand in hand to ensure structures are in place for compliance with all regulatory bodies. Tax planning and cash flows are considered in all potential alternatives. These costs are often incurred over several years while preparing, implementing, and finalizing the deal.

Chartered Business Valuation / Appraisal - In many cases, the buyer or lender may request an asset appraisal or a business valuation. An asset appraisal can be completed by an Accredited Appraiser, when documentation is required as proof of validity. A business valuation is prepared by a Chartered Business Valuator (CBV). In situations where the business valuation may need to be justified to Canada Revenue Agency or to another party in a court of law, a CBV is required. These services are often trust-builders, so all parties feel it is fair, and there is no bias. Fees are set by the professionals providing the services. It is advisable to ask for quotes for these services. It is common for these one-time fees to exceed $5,000.

Transaction Advisors - Once a potential buyer or buying group has engaged with the seller, the services of a transaction advisor will support the offer, negotiations and due diligence process working towards a successful close. These services may be provided by a business broker or a seller may manage the sale themselves with the assistance of their lawyers and accountants or a transaction advisor. Transaction advisors often work on a fee for service model and may adjust fees should a success fee be negotiated as part of their contract. These costs are incurred during the negotiation - once a buyer has been identified and moved forward from the offer or Letter of Intent stage.

Business brokers often have criteria for the size of business they want to work with. They are engaged when seeking a 3rd party buyer. They either manage the sale on a seller's behalf, or if working for the buyer, will negotiate the deal and support the due diligence process. Business brokers often charge an engagement fee up front to offset the initial marketing and listing expenses and receive a success fee ranging from 8 - 12% of the final negotiated purchase price. In some provinces Business Brokers are required to be licensed real-estate agents. Be sure to do your due diligence on selecting a Business Broker to work with. It is important to note that business brokerage is an unregulated profession and there is great diversity in experience and expertise found in the industry.

PART 3

Next Steps

It is common for business leaders to seek advice and input from accountants and financial advisors throughout the lifecycle of their business. When business transition is being considered, many additional factors need to be explored. Besides minimization of taxes and compliance with regulations, there are many alternatives, strategies and potential management decisions that can make the exit beneficial for the business owner, the business, the employees, and the community. As with many strategic conversations, the sooner these conversations happen, the better the results!

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Few business owners contemplate their business exit from a position of strength. Although they have a good understanding of the industry in which they operate, their expertise and experience in business transactions is often lacking. According to the Exit Planning Institute, 70-80% of businesses that go to market don't sell. Although the reasons are varied, they can be classified into two broad categories:

1. Owner's expectations are not realistic
2. Business is not ready to sell

To close a business transaction, the seller may need to play a role during a transition period: as a lender (Vendor Financing), as an employee/contractor, or as a minority shareholder. The bankability of the target business, the personal situations of the buyer and seller, and the characteristics of the deal itself can enable or hinder the probability of a successful transition.

With bias in the Canadian Income Tax system, advisors and their clients need to understand the pros and cons of share, asset or hybrid deal structures allowing them to more effectively ready the business for exit, and to negotiate a fair deal for both parties.

An Exit to Community plan is a viable alternative for any business owner to consider. It supports the legacy of the business and its economic impact in the community. The two most common ways for that to happen are the establishment of an employee/worker co-operative or through financing from an Opportunity Development Co-operative.

Getting Started

The goal of this guide is to start a broader conversation about the legacy of your, or your client's business. There is lots of work ahead, yet there are a few things you can start right away.

1. Set up a coffee meeting (one-on-one or virtual) to discuss exit options with your business advisor, or business client.
2. Take the Exit Options Self-assessment to explore the potentials for the business exit
3. Explore Exit to Community options and seek examples that fit with your exit goals.

Great Resources to Explore

CATEGORY	ORGANIZATION	WEBSITE
Exit & Acquisition Services	VillageWellth	https://www.villagewellth.com/
Co-operative Business Structures	Canadian Worker Co-operative Federation	https://canadianworker.coop/
	Alberta Community and Co-operative Association	https://www.acca.coop/
	Co-operatives First	https://cooperativesfirst.com/
	Community and Co-operative Counsel	https://www.coopcounsel.ca/
Employee Share Ownership	ESOP Builders Inc	http://esopbuilders.com/
	Social Capital Partners ESOP Fund	https://www.socialcapitalpartners.ca/esop-fund
	ESOP Association of Canada	https://www.esopcanada.ca/
Opportunity Development Co-operatives	Local Investing YYC	https://localinvestingyyc.ca/
	Community Impact Investment Coalition	https://ccednet-rcdec.ca/en/page/bc-community-impact-investment-coalition
	Alberta Community and Co-operative Association	https://www.acca.coop/

Learn more about options for an Exit to Community by contacting the Alberta Community and Co-operative Association at info@acca.coop or 1.780.963.3766.

To learn more about succession and exit planning, contact a specialist in your region. Look for the CEPA designation.[1]

Create ways to have conversations with other business owners and your advisor team (legal, tax, accounting, wealth management, etc.). Learn as much as you can about all exit options and how to incorporate the best fit into a business strategy. Connect with regional and local organizations such as Community Futures.

Part 3 Endnote

1. Canadian CEPA's can also be searched for at https://exit-planning-institute.org/people-locations/united-states/canada/

Appendix 1

Role of Co-operatives in the Business Landscape

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This guide focuses on benefits to business owners when selling their business to employees or an Opportunity Development Co-operative. This work is part of a larger conversation happening across Canada about the broader role co-ops can play in providing succession planning solutions to business owners. It focuses on a business conversion to co-operative (BCC) and takes place when private, public, or non-profit companies transition into a co-operative structure (for a variety of reasons).

A Co-operative is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise" (www.ica.coop). Put simply, a co-op is a business owned and controlled by member-owners who use and benefit from its services. Co-ops are a form of limited liability corporation and are incorporated under the federal or provincial co-operative act. They are guided by internationally accepted co-operative principles and values.

Co-ops can be found in all parts of the economy. Co-ops will differ based on the type of member-owners: consumers, producers, or workers. This guide also discussed Opportunity Development Co-operatives, which is a unique form of co-op but can be very impactful. Its members are local investors. Lastly, there are multi-stakeholder co-ops that have more than one membership group, and each group receives a different benefit from the same co-op (for example a co-op hardware store that is owned by workers and consumers). Co-ops of any form could be a solution for Exit to Community.

In Canada, most conversions occur as part of a succession plan whereby a retiring owner or owners sell their business to staff and they, in turn, continue to operate the enterprise as a co-operative. BCCs can also occur as a community buyout (where consumers and other community stakeholders purchase the enterprise), or a multi-stakeholder buyout (where employees and other community stakeholders purchase the enterprise). A unique model to Quebec, a partial conversion occurs when a worker-shareholder co-operative (WSC) is formed by employees and they enter into co-ownership agreements with traditional investors; sometimes WSCs are a stage in the eventual full conversion of the enterprise into a co-operative[1].

A business conversion to cooperatives (BCC) is a tried and tested solution for business rescue and succession. Compared to a corporation, which is created to maximize shareholder returns, a co-operative is created to meet the needs of its members. Yes, a co-op can be profitable and competitive in the market. However, the workers who own and control where they work could create a shift in their strategic priorities. For example, a privately owned cleaning business is typically based on maximizing revenue and minimizing labour costs. Yet, if those cleaners collectively own the business, their goals are to: 1) provide long-term employment, 2) have better wages, and 3) find more and better wage-earning opportunities. As such the worker-owned business may invest in training and education in management, operations, and business development, thereby increasing worker engagement and productivity while reducing turnover and management costs. Worker ownership tends to appeal to workers who are motivated by the overall success of the business and want to work for a great employer. In a co-operative, every worker/person has one vote.

Co-operatives often save the business from closing thus preserving the jobs and economic impact in the community. The business continues to maintain a facility, pay municipal taxes and is often a customer of other local businesses. The employees and their families consume goods and may be engaged in a wide-range of services in the community (schools, churches, sports, volunteer organizations, etc.). They make their community their home and invest in it socially, emotionally, mentally, physically, and financially.

Absentee owners, on the other hand, often drain the capital from the community, spending the profits earned in the community of their residence. On the upside, they invest outside capital in a community, thereby freeing local capital for other productive uses.

Starting a Co-operative

Exit to Community using the co-operative structure often requires starting a new co-operative. Fortunately, there are ample resources. Establishing a consumer, producer, or worker co-operative follow similar development pathways. Some of the main elements of this pathway are:

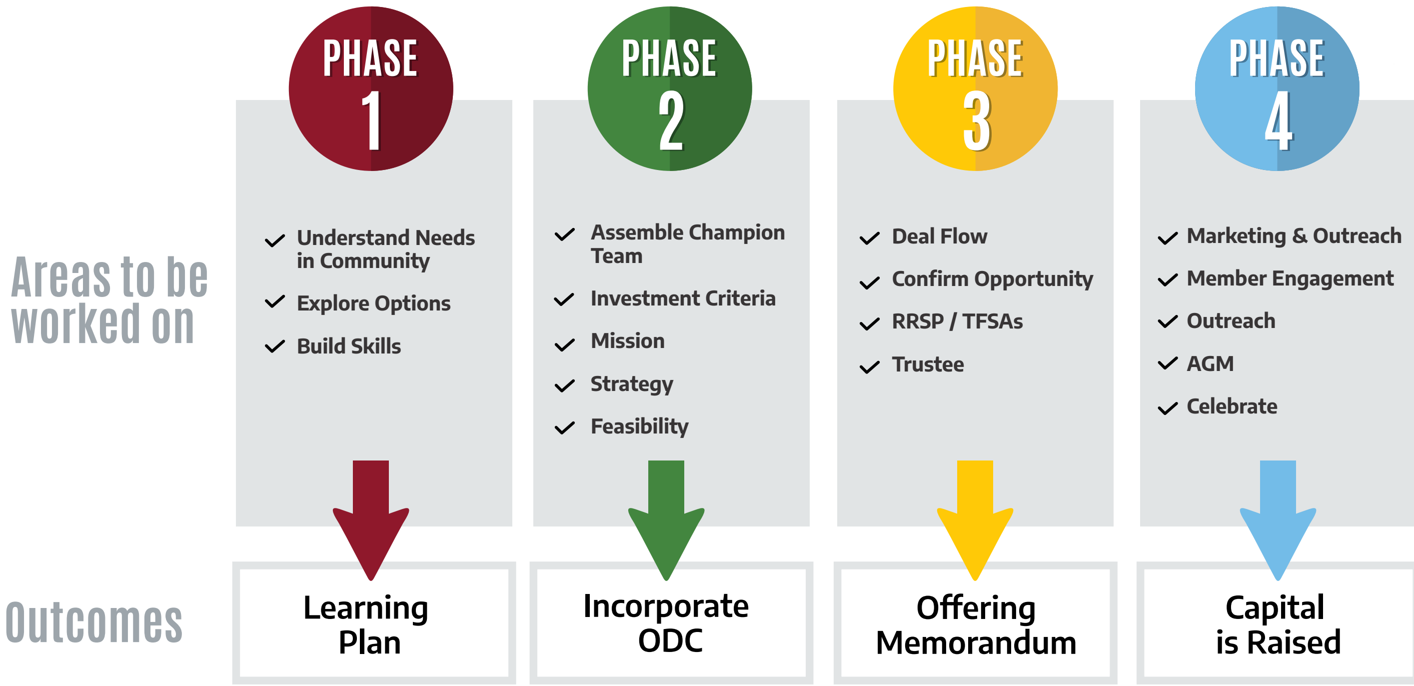
1. **Form a steering committee to explore and assess opportunities and challenges**
    a. How might owning a business together meet a need?
    b. What are examples of other groups doing this exceptionally well?
    c. What would the benefits be in the broadest forms?
    d. What will happen to the stakeholders if this project does NOT happen (i.e., what is the opportunity cost of inaction?)
    e. Celebrate the learnings and decisions
2. **Conduct a Feasibility Assessment/Case for Support**
    a. Is the business idea viable?
    b. Is the business sustainable for the long-term?
    c. Will the intended stakeholders be interested in becoming owners?
    d. Celebrate the learnings and decisions
3. **Co-creation of a strategy and business plan with stakeholders**
    a. Steering committee presents business concept to prospective members for feedback
    b. Stakeholders decide to join the co-op once it is incorporated
    c. Create a business plan
    d. Draft mission, vision, and values of the co-op
    e. Develop a work-plan that includes incorporation of the co-op, launching the business, and excelling in the first 18 months
    f. Celebrate the learnings and decisions
4. **Develop corporate documents that reflect the mission and business plan**
    a. Confirm co-op name
    b. Meet with a lawyer and accountant
    c. Create articles of incorporation and bylaws – follow the incorporation process as per provincial or federal requirements
    d. Celebrate the learnings and decisions

5. **Hold first Annual General Meeting with owner members to appoint founding board, approve bylaws, and celebrate**
6. **Launch the business or complete the transition, and celebrate**
    a. Raise some money
    b. Determine who is willing to front the cash to start the exploration and risk the investment
7. **Celebrate and thrive as a co-op**

Setting up a co-operative is different than incorporating a privately held business. Working with legal advisors who understand the legislation helps reduce frustrations from business owners and their employees when seeking to establish a co-operative. A minimum of three directors is required to establish a co-operative making it a viable alternative for many businesses to consider. Co-operatives First's Co-op Creator[1] provides an excellent step-by-step guide to forming a co-op.

Forming an Opportunity Development Co-operative (ODC) follows a similar approach, however there are other elements to consider. The figure below provides an overview. To learn more about ODCs and the development process, please contact the Alberta Community and Co-operative Association (info@acca.coop, www.acca.coop)

FIGURE 7: ODC PROCESS



Appendix 1 Endnotes

1. Vieta, M., Tarhan, D. Duiguid, F, Guillotte, C. (2021) Canada's SMEs, Business Succession, and Conversion to Co-operatives. Co-Op Convert, Retrieved April 12, 2021 from https://drive.google.com/file/d/1cQaNcwPyGD3rhirtNjRPx82oQQ-QOb37/view

2. https://coopcreator.ca/

Appendix 2

Comparison
Asset Sale to Share Sale

	ASSET SALE	SHARE SALE
SELLER - PROS	• No need to cleanse the company • Can retain use of company for other purposes • Does not require any clean-up of intercompany or related party balances • Cheaper, as there are lower compliance costs when not needing to meet QSBC requirements • More buyers at the table • Negotiate higher sale price to achieve comparable after-tax proceeds to share sale	• Maximize after tax cash • Easier on the team - no terminations of staff
SELLER - CONS	• Higher taxes, lower proceeds may be realized depending on tax cost of assets • Higher sales price • May require an asset appraisal if no ready market values are available	• May not qualify for LCGE • Requirement to clean up intercompany & related party amounts with potential tax consequences • Increased due diligence to confirm completeness and value of all assets and liabilities • May require review or audit • Chartered Business Valuation may be required
BUYER - PROS	• Bump up in cost base for tangible assets allowing for higher amortization and CCA claims resulting in minimizing future taxes • No assumption of liabilities of company • Not buying assets they don’t want - i.e. obsolete, uncollectable • Not assuming liabilities for loans, trade payables, potential claims or assessments • Don’t inherit any bad contracts • Do not buy staff	• Easier to assume contracts in place with company, take over existing bank accounts, suppliers and other relationships • Continuity of staff - i.e. no layoffs / severance and then re-hiring • May be able to negotiate price on lower end of valuation as seller has lower taxes
BUYER - CONS	• Often higher price negotiated to compensate for seller’s additional taxes • May require assignment of contracts • Do not buy staff • Need to negotiate terms with suppliers and staff	• Assume all liabilities of the company including potential liabilities from legal claims. • Documentation for change in control – CRA requirements are significant • Bank and credit card processors may freeze of terminate accounts • Company contracts may also have change in control rules • Potentially stuck with undesired contracts

Appendix 3
Checklist - Exit Options

Internal Exit Options

Sale to Workforce: Contractors, Employee(s) and / or Managers

- ☐ Does the business have one or more managers/employees/contractors who have the capacity to operate and grow the business?
- ☐ Do they have funds available to contribute to financing?
- ☐ Do they have family / friends willing to co-sign on financing?
- ☐ Are they members of groups who may be able to access grants or program loans?
- ☐ Is the business able to cash flow dividends or salary to them to make payments?
- ☐ Will the seller participate in financing the deal?
- ☐ Is the business able to pay salaries to replace the work done by the exiting owner?
- ☐ Is the owner willing to stay on in some capacity to help mentor and transition the business?

Sale to Family

- ☐ Are there family members currently employed in the business? If so, do they have the capacity and passion to run the business?
- ☐ Are there extended family members who can be approached?
- ☐ Can the business cash flow payments to workers and have family owners "hands off"?
- ☐ Is anyone in the family interested in carrying on the business?
- ☐ Will the seller participate in financing the sale?
- ☐ Does the owner want to fully retire, or to continue participation in the business?

Sale to Group of Employees (Employee Stock Ownership Plan)

- ☐ Does the business have the equivalent of 10+ full time employees?
- ☐ Does the owner want to exit over a longer period of time (i.e. 5 – 10 years)?
- ☐ Is the owner 100% supportive of the ESOP model and willing to grow the culture?
- ☐ Is there a team of employees who will act as Champions?
- ☐ Do employees have the desire and financial capacity to purchase stock on an annual basis?
- ☐ Is the owner willing to continue in their role and develop a governance structure to eventually take over decision-making?

Sale to Group of Employees (Worker Co-operative)

- ☐ Does the business have the equivalent of 5 full time employees?
- ☐ Does the business have one or more managers/employees/contractors who have the capacity to operate and grow the business?
- ☐ Do the employees have funds available to contribute to financing?
- ☐ Is the business able to cash flow salary to them to make payments?
- ☐ Does the owner want to fully retire, or to continue participation in the business?

Sale to Partner

- ☐ Is the partner willing to buy your shares?
- ☐ Does the Unanimous Shareholder Agreement / Partnership Agreement allow for ease of sale?
- ☐ Can the partner finance the transaction?
- ☐ Is the seller willing to participate in financing the sale?

External Exit Options

Sale to 3rd Party

Sale to Strategic Buyers (including existing Co-Operative)

- ☐ Is there strategic value to a buyer?
- ☐ Is the business the right size to attract a strategic buyer?
  - ☐ Top Line Revenue
  - ☐ Profitability
  - ☐ Workforce
- ☐ Is the price right?
- ☐ Is the business working without hands-on owners?
- ☐ Is there a strategic buyer in another region who is interested in expanding geographically through acquisition?
- ☐ Is there a strategic buyer with complementary services/products who may want to add a division to their existing business?
- ☐ Are there local competitors who are interested in gaining more market share through acquisition of their competition?

Sale to Private Equity

- ☐ Are private equity firms looking for deals in this sector?
- ☐ Does the business offer ROI to meet investment criteria?
- ☐ Can the business be improved and sold again in the timeline for private equity?
- ☐ Is there sufficient cash flow to finance the debt?

Sale to Individual

- ☐ Is the business affordable for an individual buyer?
- ☐ Are there ideal buyers already looking for this type of business?
- ☐ Will the Vendor participate in financing the deal?
- ☐ Will the new owner need to operate the business?
- ☐ Will the Vendor stay for a period of time to mentor the new owner?

Sale to Social Enterprise

Municipality

- ☐ Does the business fit within the mandate of the local government?
- ☐ Will this acquisition benefit rate payers or increase taxes?
- ☐ Would acquiring this business bring a local service provided to residents in-house?

Not-for-profit

- ☐ Is there a cause whose mandate would fit with this type of business?
- ☐ Is there a board with the business acumen to run the business?
- ☐ Is the business able to contribute cash flows to further the organization's mission?

Charity

- ☐ Can the business activity be tied to its charitable work and still maintain the registered status?
- ☐ Does the board have the competency to operate the business?
- ☐ Is there a mission / mandate match?

Co-operative (Opportunity Development Co-operative)

- ☐ Is there a champion team of local citizens willing to organize and facilitate the process?
- ☐ Are there local / regional investors or stakeholders who, as a group, can raise funds to buy the business and oversee it?
- ☐ Are there employees or contractors who have the capacity to operate and grow the business?
- ☐ Are existing employees willing to continue working in the business under new management?

Recapitalization (partial sale)

- ☐ Is the owner willing to continue with an ownership interest?
- ☐ Is the company "clean" enough to use with the new ownership model?
- ☐ Is the owner willing to purge personal perks from the business and operate with FMV (fair market value) and arm's length deals?
- ☐ Is the owner willing to adjust the debt or equity in the company?

Orderly Liquidation

- ☐ Is there any value in the company that can be sold off?
- ☐ Is there a market for tangible assets?
- ☐ Is there a potential acquirer for intangible assets (i.e. start-ups, competitor or complementary)?
- ☐ Is the value of the individual assets more than the value of the company?

Appendix 4
Case Study Data and Calculations

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	COST	TAX VALUES	FMV
Cash + cash equivalents	$60,000.00	$60,000.00	$60,000.00
Accounts receivable	$7,300.00	$7,300.00	$7,300.00
Inventory	$21,000.00	$21,000.00	$21,000.00
Building	$84,000.00	$60,000.00	$180,000.00
Vehicle - Class 10 Equipment (UCC)	$9,000.00	$3,000.00	$15,000.00
Furniture, Computers, Equipment - Class 8 Equipment (UCC)	$60,000.00	$85,000.00	$ 149,634.00
Total Assets	**$241,300.00**	**$236,300.00**	**$722,300.00**

Liabilities			
Accounts payable	$25,000.00	$25,000.00	$25,000.00
GST Payable	$3,750.00	$3,750.00	$3,750.00
Due to related parties	$45,000.00	$45,000.00	$45,000.00
Total Liabilities	**$73,750.00**	**$73,750.00**	**$73,750.00**

Shareholder Equity			
Share Capital / Paid-Up Capital	$10.00	10	
Retained earnings, beg.	$67,530.00		
Other Adjustments			
Net Income	$100,010.00		
Dividends			
Retained earnings, end.	$167,540.00	$167,540.00	
Total Equity	**$167,550.00**	**$167,550.00**	
Liabilities + Equity	**$241,300.00**	**$241,300.00**	

Valuation - Share Sale	-		$475,000.00
Valuation - Assets			$475,000.00

Share Sale After Tax

Proceeds from Sale of Shares	**$475,000.00**
ACB	10
Capital Gain	**$474,990.00**
Taxable portion of Capital Gain	50%
Taxable Capital Gain	**$237,495.00**
Capital Gains Exemption	$237,495.00
Net included in Taxable Income	**$ -**
Tax	$ -
After tax proceeds	**$475,000.00**

IMPLICATION OF ALTERNATIVE MINIMUM TAX (AMT) CAN BE APPLIED

Note 1:

Assuming the shares are qualified small business corporation shares ("QSBC")

However, Alternative Minimum Tax (AMT) will be relevant in the current year, given the size of the gain. While this would likely not be a permanent cost, it would reduce current cash flow. (We ignored personal tax credit in the calculation below):

Calculation of AMT per shareholder:	
"Normal" taxable income	Nil
Capital gain	237,495.00
30% of capital gain (A)	71,248.50
Non-taxable portion of capital gain (B)	237,495.00
Enter the amount from line (A) or (B), whichever is less	**$71,248.50**
Basic exemption	(40,000.00)
AMT taxable income	**31,248.50**
Federal AMT @ 15% per T691	$4,687.28
Provincial AMT @ 35% of Federal AMT per T1219	$1,640.55
Total obligation to pay AMT	**$6,327.82**
If "Normal" taxable income is available, it is also subject to AMT.	

Asset Sale – After Tax Proceeds

The allocation of proceeds of $454,000 to fixed assets resulted in the following gains being realized:						475,000.00
						(21,000.00)
						454,000.00
	Cost	**UCC**	**CEC**	**Fair Market Value**	**Recaptured Depreciation**	**Capital Gain**
Class 10	9,000.00	3,000.00		27,240.00	N/A	18,240.00
Class 8	60,000.00	85,000.00		177,060.00	-	117,060.00
Building	84,000.00	60,000.00		249,700.00	24,000.00	165,700.00
Goodwill	-			-		-
	$153,000.00	**$148,000.00**	**$-**	**$454,000.00**	**$24,000.00**	**$301,000.00**
				Costs and outlays		
					Commission	$-
					Legal fees	$-
					Capital gain	$301,000.00

A)	**Calculation of corporate taxable income:**			
		Recapture	24,000.00	**11%**
		Gain from sale (50%)	150,500.00	**20%**
		Taxable gain from sale of assets	174,500.00	
		Calculation of corporate tax (federal-provincial combined)	32,740.00	

I)	**Calculation of cash available for distribution to shareholder:**		
		Cash from sale of assets	454,000.00
		Taxes payable from sale of assets	(32,740.00)
		Total liabilities (balance sheet)	(73,750.00)
		Total after-tax corporate cash available	**347,510.00**
	Calculation of distribution to shareholder:		
		Corporate cash available for distribution as a dividend	$347,510.00
		Capital dividend account	(150,500.00)
		Balance = actual dividend to distribute to shareholder	**$197,010.00**

B)	**Calculation of personal tax to shareholder:**		
		Calculation of taxable income:	
		Actual dividend received	$197,010.00
		Gross-up dividend	29,551.50
		Taxable dividend	**$226,561.50**
		Calculation of personal tax (federal-provincial combined)	
		Dividend @ 42.31%	**$83,000.31**
C)	**Calculation of after-tax cash to shareholder:**		
		Total proceeds from sale of assets	$475,000.00
		Cash	$60,000.00
		AR	$7,300.00
		Total liabilities (per balance sheet)	$(73,750.00)
		Corporate taxes payable from sale of assets	(32,740.00)
		Personal tax (see above)	(83,000.31)
		After-tax cash to shareholder	**$352,809.69**
	Compare		
		Net proceeds Share Sale	$475,000.00
		Net proceeds Asset Sale	$352,809.69
		Difference	**$122,190.31**

Auto Shop

Assets	Book Value	Tax Values	FMV
Cash + cash equivalents	$60,000.00	$60,000.00	$60,000.00
Accounts receivable	$7,300.00	$7,300.00	$7,300.00
Inventory	$11,850.00	$11,850.00	$11,850.00
Vehicle - Class 10 Equipment (UCC)	$460.00	500	$1,500.00
Furniture, Computers, Equipment - Class 8 Equipment (UCC)	$43,200.00	15000	$76,750.00
Total Assets	**$122,810.00**	**$94,650.00**	**$157,400.00**
Liabilities			
Accounts payable	$14,050.00	$14,050.00	$14,050.00
GST Payable	$3,750.00	3,750.00	3,750.00
Due to related parties	$45,000.00	$45,000.00	$45,000.00
Total Liabilities	**$62,800.00**	**$62,800.00**	**$62,800.00**
Shareholder Equity			
Share Capital / Paid-Up Capital	$10.00	10.00	10.00
Retained earnings, beg.	$20,000.00		
Other Adjustments			
Net Income	$40,000.00		
Dividends			
Retained earnings, end.	$60,000.00	60,000.00	60,000.00
Total Equity	**$60,010.00**	**$60,010.00**	**$60,010.00**
Liabilities + Equity	**$122,810.00**	**$122,810.00**	**$122,810.00**

Proceeds from Sale of Shares	$170,500.00
ACB	10
Capital Gain	$170,490.00
Taxable portion of Capital Gain	50%
Taxable Capital Gain	**$85,245.00**
Capital Gains Exemption (Qualify for the exemption - 2 years rule)	$85,245.00
Net included in Taxable Income	$-
Tax	$-
After tax proceeds	**$170,500.00**

IMPLICATION OF ALTERNATIVE MINIMUM TAX (AMT) CAN BE APPLIED

Note 1:

Assuming the shares are qualified small business corporation shares ("QSBC")

However, Alternative Minimum Tax (AMT) will be relevant in the current year, given the size of the gain. While this would likely not be a permanent cost, it would reduce current cash flow.
(We ignored personal tax credit in the calculation below):

Calculation of AMT per shareholder:	
"Normal" taxable income	Nil
Capital gain	$85,245.00
30% of capital gain (A)	$25,573.50
Non-taxable portion of capital gain (B)	$85,245.00
Enter the amount from line (A) or (B), whichever is less	$25,573.50
Basic exemption	$(40,000.00)
AMT taxable income	**$-**
Federal AMT @ 15% per T691	$-
Provincial AMT @ 35% of Federal AMT per T1219	$-
Total obligation to pay AMT	**$-**
AMT may recoverable in subsequent years.	
If "Normal" taxable income is available, it is also subject to AMT.	

Proceeds from Asset Sale

The calculations are based on the assumption that the assets are sold at the same time. The allocation of proceeds of $170,500 to fixed assets resulted in the following gains being realized:						170,500.00
						(11,850.00)
						158,650.00
	Cost	**UCC**	**CEC**	**Fair Market Value**	**Recaptured Depreciation**	**Capital Gain**
Class 10	460.00	500.00	1,671.53	N/A	1,211.53	
Class 8	43,200.00	15,000.00	156,978.47	28,200.00	113,778.47	
Inventory						
Goodwill		-	-		-	
	$43,660.00	$15,500.00	$-	$158,650.00	$28,200.00	$114,990.00
				Costs and outlays		
					Commission	$ -
					Legal fees	$ -
					Capital gain	**$114,990.00**

A)	**Calculation of corporate taxable income:**			
		Recapture	28,200.00	11%
		Gain from sale (50%)	57,495.00	20%
	Taxable gain from sale of assets		**85,695.00**	
	Calculation of corporate tax (federal-provincial combined)		**14,601.00**	
	I)	Calculation of cash available for distribution to shareholder:		
		Cash from sale of assets		170,500.00
		Taxes payable from sale of assets		(14,601.00)
		Total liabilities (balance sheet)		(62,800.00)
		Total after-tax corporate cash available		**93,099.00**
	Calculation of distribution to shareholder:			
		Corporate cash available for distribution as a dividend		$93,099.00
		Capital dividend account		(57,495.00)
		Balance = actual dividend to distribute to shareholder		**$35,604.00**
B)	**Calculation of personal tax to shareholder:**			
		Calculation of taxable income:		
		Actual dividend received		$35,604.00
		Gross-up dividend		5,340.60
		Taxable dividend		**$40,944.60**
		Calculation of personal tax (federal-provincial combined)		
		Dividend @ 22.18%		**$7,896.97**
C)	**Calculation of after-tax cash to shareholder:**			
		Total proceeds from sale of assets		$170,500.00
		Cash		$60,000.00
		AR		$7,300.00
		Total liabilities (per balance sheet)		$(62,800.00)
		Corporate taxes payable from sale of assets		(14,601.00)
		Personal tax (see above)		(7,896.97)
		After-tax cash to shareholder		**$152,502.03**

COMPARE

Net proceeds Share Sale	$170,500.00
Net proceeds Asset Sale	$152,502.03
Difference	**$17,997.97**

Exit to Community

A Business Transition Guide for Business Advisors & Business Owners

TO LEARN MORE, PLEASE CONTACT:

Seth Leon, MDE, Alberta Community and Co-operatives Association
EMAIL: sleon@acca.coop or
CALL: 587-216-2144
VISIT: www.exitguide.info | www.acca.coop