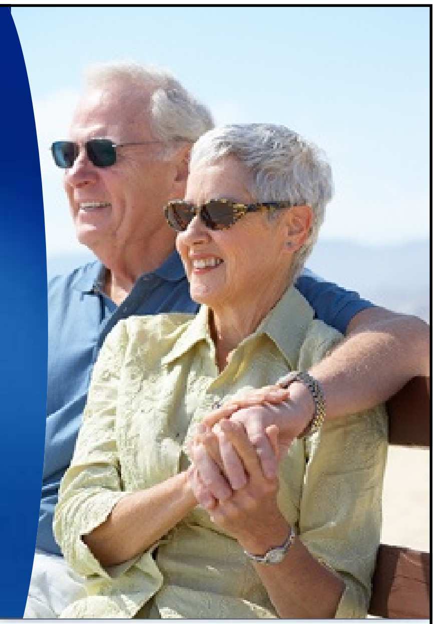
Succession Planning for Small and Medium-Sized Enterprises (SME)



RBC Insurance®

RBC Life Insurance Company

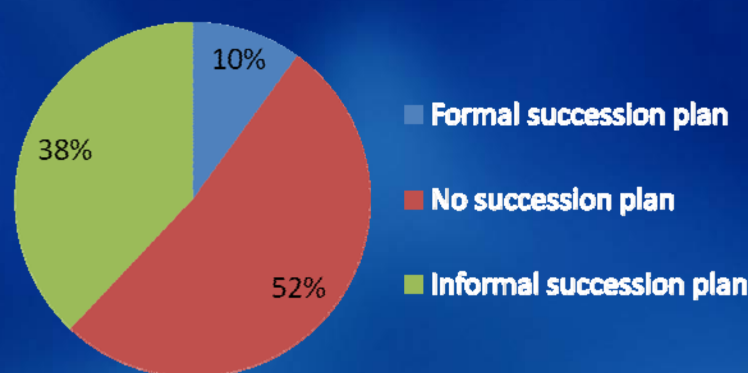
The information in this presentation is being presented for general knowledge and the content should not be relied upon as containing specific financial, investment, tax or related advice. Clients must seek their own independent professional advice to discuss their own unique circumstances before implementing this type of arrangement

SME Business Realities

Every business owner at some point will either have to sell their business or the assets comprising the business, or pass on their company to the next generation

If that time is today or in the near future, odds are stacked heavily against them realizing the fair value of their business if they don't have a succession plan

Existence of succession plan



* Canadian Federation of Independent Business (CFIB). Survey results 2006

What is a Succession Plan?

Succession planning is a process where you develop and document a strategy regarding how to divest of your business interest under various scenarios to achieve your desired outcome

Why should you care?

- Your business may be one of your most significant assets
- You and others may depend on the continuation or effective transition of the business
  - Retirement
  - Legacy
  - Employment

Reason for Planning

To help ensure that the transition of your business will happen as you desire

- Spouse or family will not be brought into the business unwillingly
- Courts are not required to determine the outcome of the transition
- Business partners are not adversely impacted
- Business values are not lost or minimized

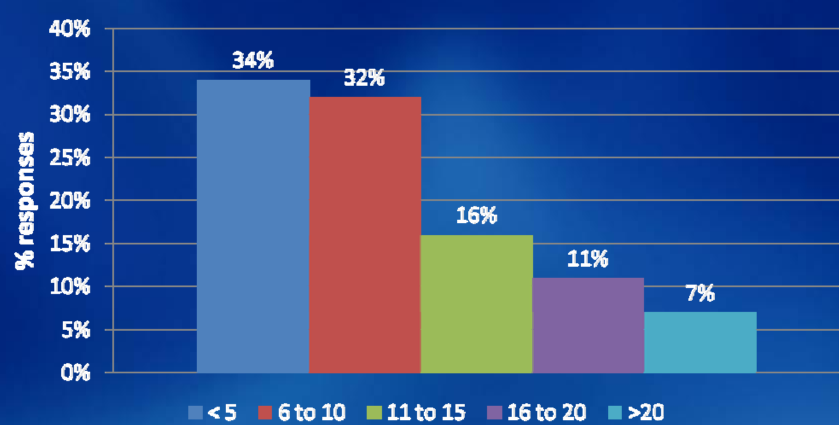
Well designed succession plan will help …

- Ensure future financial stability and value of the business
- Reduce potential tax liability from transferring ownership
- Set a timeline for transfer of ownership
- Provide stability for employees
- Help ensure a smooth transition

Timing

You should put your succession plan in place at least 5 years prior to any transition, and ideally, you would leave yourself eight to ten years

Exit Timeline for SME Owners *



* Canadian Federation of Independent Business (CFIB). Survey results 2006

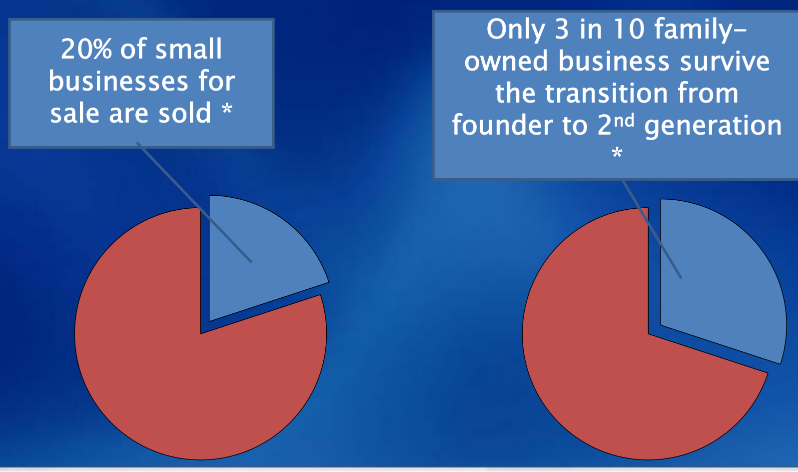
Transition Strategy Considerations

- When will you retire?
- Who will take over the management of the business after you?
- Will you play some continuing role for a period of time?
- How will ownership be transferred?
- What is your business worth?
- Putting the business in order for the transition
- Who will help you with this process?

Key components of a Succession Plan

- Transition Strategy
- Shareholder agreement (whenever there are multiple shareholders this is essential)
- Co-ordination with personal estate planning
  - Retirement plans
  - Will, (distribution of estate assets)
- Insurance
- Succession team

Small Business Transition Facts



* Canadian federation of independent business, May 2004

Why families don’t retain their business

- No qualified successor
- No succession planning
  - Family may be forced to sell the business due to unexpected financial difficulties
- No will to make difficult decisions
  - Pick one child as successor – how to treat the others fairly?

Business Transition Alternatives

Pass it on to family

Sell to employees, strangers

Wind-up

Business Transition Plan Survey

- Pass it to family
  - Transfer 16%
  - Sale 10%
- Sell to non-family members 37%
- Wind-up 4%
- Other 6%
- No plan 26%

Risks or Events that may Impact your Business

- Economic or business risks
- Property or liability risks
- Death
- Disability or illness
- Retirement

Addressing business continuation risks

Shareholder agreements

Buy/sell provisions

Key person protection

What are buy-sell provisions

- They form part of the shareholder agreement and address the transfer of a business interest following the death, disability, retirement, or voluntary exit of a business owner
- They address the rights and obligations of the parties with respect to share ownership transfers

Buy-sell provision essentials

- Conditions that would trigger a mandatory sale
- The purchase price
- The buyer of the shares
- The terms of the sale
- The timing of the sale
- The funding source

Funding buy-sell agreements

Insurance

- Often the cheapest and most tax effective way to finance obligations to buy/sell shares
- Good health buys insurance, money only pays for it
- Need to act quickly to keep costs down and ensure the option is still viable

Alternative buy-sell arrangements

- Criss-cross, personal
- Criss-cross, promissory note
- Share redemption
- Hybrid

Criss-cross, personally owned insurance

- Description
  - Insurance bought on each other's life
- Advantages
  - Simple to structure
  - Surviving owner has an increased Adjusted Cost Basis (ACB)
  - Creditor protection
- Disadvantages
  - Premium discrepancy re: age differences
  - Premiums paid with individual after tax dollars
  - Multiple policies on the same lives when several parties involved
  - Difficult to control and deal with if a disagreement arises
  - Heirs of the deceased subject to capital gains tax on sale

Criss-cross, promissory note

- Description
  - Survivor purchases deceased's shares with a promissory note that will be repaid with proceeds from a tax free dividend funded by insurance death benefits
- Advantages
  - Premiums paid with after-tax corporate dollars
  - No premium disparities
  - Surviving owner has an increased ACB
- Disadvantages
  - Heirs of the deceased subject to capital gains tax on sale
  - Not creditor proof

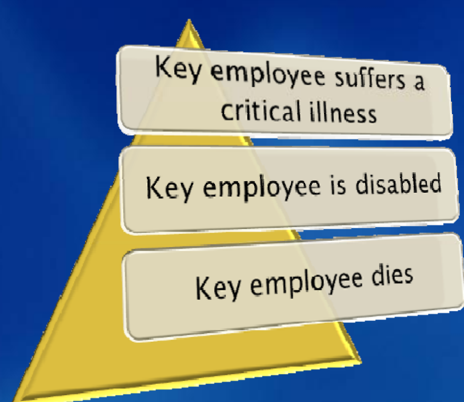
Share redemption

- Description
  - Deceased's shares redeemed by the corporation after death
- Advantages
  - Premiums paid with after-tax corporate dollars
  - No premium disparities
  - Heirs of the deceased may be eligible to receive a portion of the sale proceeds tax free
  - Capital Dividend Account (CDA) not utilized by redemption of deceased shares remains for survivor
- Disadvantages
  - Not creditor proof
  - More complex
  - No increase in ACB for surviving shareholder

Hybrid

- Description
  - Combination of share redemption and promissory note methods to maximize tax advantages
- Advantages
  - Premiums paid with after-tax corporate dollars
  - No premium disparities
  - Surviving shareholder gets partial increase to ACB
  - Heirs of the deceased may be eligible to receive a portion of the sale proceeds tax free
  - CDA not utilized by redemption of deceased shares remains for survivor
- Disadvantages
  - Complicated
  - Not creditor proof

Key person protection



Risk to the business

Reduced business effectiveness

Costs to replace the individual

Creditors may impede credit

Payment term may be tightened

Negative customer reaction

Insurance solutions

Key person life insurance

Key person disability insurance

Key person critical illness insurance

Key person life insurance

- Availability based on health
- Issue ages typically between 18 to 60
- Proposed insured typically would have special expertise and skills, revenue producing ability and or add reputation to the business
- Benefit tied into multiple of salary that varies as the insured gets closer to retirement, or losses that can be demonstrated
- Corporate owned, funded, and beneficiary

Key person disability insurance *

- Availability based on health, industry type and occupation class of the proposed insured
- Issue ages typically between 18 to 55
- Ownership interest less than 50%
- Maximum benefit available $15,000 per month with either a 60 or 90 day elimination period
- Benefit period up to 12 months
- Benefit tied into multiple of salary that varies as the insured gets closer to retirement

* Based on RBCI current key person disability contract

Key person critical illness insurance *

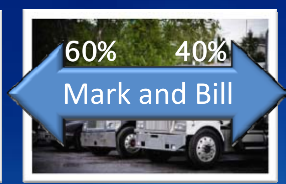
- Availability based on health of proposed insured
- Issue ages between 18 to 65
- Benefit tied into multiple of salary that varies as the insured gets closer to retirement
- Maximum benefit is $2M

* Based on RBCI current critical illness contract

Case study

The players

Helen



Dave

Susan

- Helen and her daughter Susan are not involved in the business
- Dave works for his dad, but is not yet a shareholder
- Mark wants Dave to eventually be the owner

Mark is suddenly diagnosed with terminal cancer and passes away within three weeks

Everyone is in Shock

There is no succession plan in place

What could happen without a plan

- Will leaves everything to Helen
- Bill finds himself in business with Helen
- Helen needs to sell inherited shares
- Bill does not have the money to buy out Mark's shares from Helen
- Mark's shares are sold – below market value
- Dave does not take over the company – Susan may have to defer university plans
- Employee jobs in jeopardy

A more prudent approach - planning

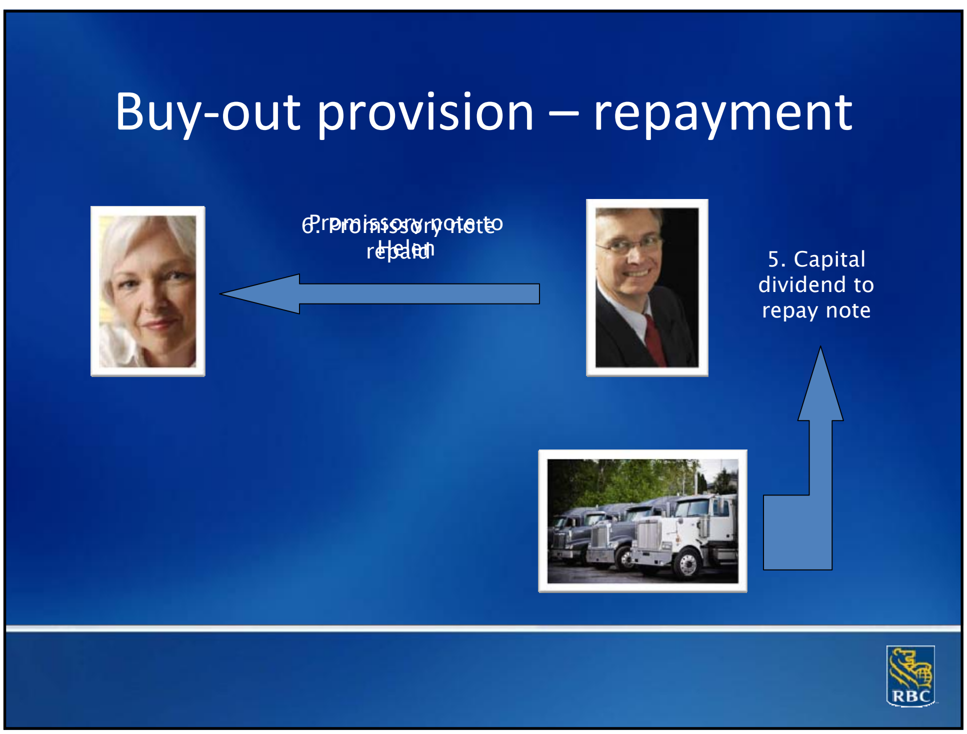
1. Shareholder agreement in place
2. Will is updated to reflect succession plan
3. Insurance is in place to fund succession and estate needs
   - To fund buy-sell agreement, ($2M on Mark, $1.5M on Bill, T20 corporate owned)
   - To provide assistance for Helen ($.5M permanent life)
   - To provide equalization for Susan ($3M JLTD permanent life)

The shareholder agreement

- Required each of them to buy the shares of the other in case of death or disability
  - Funded through corporate-owned life insurance
- David has 1st right of refusal to purchase Bill's shares at retirement or if other issues preclude him from continuing the business
- David ensured 5 years of employment after Mark's death

Buy-out provision - death


Buy-out provision – share transfer
4. Shares transferred
3. Promissory note to Helen to buy shares
RBC


Buy-out provision – repayment
Promissory note to Helen
6. Promissory note repaid
5. Capital dividend to repay note
RBC

Buy-out provision – outcome

Bill owns
100% of the
company

Dave is
manager and
future owner

Results

- Bill owns the business
  - Future purchaser identified with funding in place
- Helen receives full value for her company shares
- Proceeds from the sale of her company shares and insurance allow Helen to maintain lifestyle
- Dave has 5 years to continue learning the business and an opportunity to take it over eventually
  - Policy in place for eventual buy-out
- Susan gets to go to university to continue studies and will be equalized without impairing Dave’s ability to take over and run the business
- Business is secured and employees retain their jobs

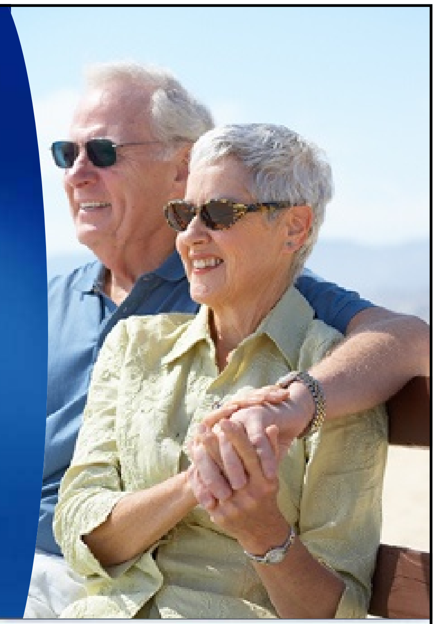
Summary of outcome

Events	With plan	Without
Funds available to Helen maximized	Yes	No
Bill takes over the business	Yes	No
Dave retains job	Yes	Maybe
Dave has opportunity to eventually take over	Yes	Not likely
Susan gets to go to university	Yes	Not likely
Susan has equalized the value of the business	Yes	No
Employees retain jobs	Yes	Maybe
Mark's desire for succession is achieved	Yes	No

Next steps

- Assess your current state of readiness
- Identify the members of the team that will help put the plan together
- Communicate intentions with family and business partners
- Make commitment to follow through

Succession Planning for Small and Medium-Sized Enterprises (SME)



RBC Insurance®