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E. Paul Abbott Financial Group Inc.

The Globe and Mail, Thursday, June 19, 2008 □

Globe Investor B15

STRATEGY » SUCCESSION

Ready to sell your business? Life insurance can make it easier for everyone



TIM CESTNICK TAX MATTERS

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Pete is a friend of mine who is, in a word, paranoid. He's always willing to share things that you should be concerned about.

In the past, I've learned that you can be electrocuted while talking on the telephone during a thunderstorm, 200,000 serious injuries happen in the bathroom each year, and excessive blinking could be an early sign of blepharospasm – a rare

muscle disorder that can cause eyelids to shut permanently.

Now, Pete is a business owner. I've told him that if he should worry about anything, it's not his eyelids, but his business succession planning, about which he's done little.

THE SURVEY

A 2005 survey by the Canadian Federation of Independent Businesses revealed that two-thirds of owners of small and medium-sized enterprises plan to exit their businesses over the next 10 years. Sadly, only about 10 per cent of business owners have any type of succession plan in place.

Two of the biggest challenges business owners face when thinking about their succession planning are income taxes (How can the tax burden on the transfer of the business be reduced?) and financing (How will the successor find the

money to make the purchase, particularly a concern if the buyer is a family member or employee of the business?).

The fact is, many business owners may be getting ready to retire, but they may not pocket the full value of the business if they're not prepared.

THE OPTIONS

There are a number of ways to skin this cat, but I'd like to share one particular strategy that involves the use of life insurance, which can both reduce the tax burden on the transfer of the business and make the financing easier, too. Consider Richard.

Richard runs a successful elevator repair company. He's now 60 years old and ready to slow down. While his children have worked in the business at different times, they aren't interested or capable of taking it over.

His best options include selling the business to an outside party or helping his management team purchase it. He decided his best opportunity to receive fair market value while providing long-term security to his employees is to sell to the management team.

THE STRATEGY

How can insurance fit into this picture? "There's an alternative that will enable Richard to reduce his tax burden and make the company very affordable for the management team to acquire," explains John Firstbrook, president and chief executive officer of Firstbrook Insurance Group in Toronto.

Mr. Firstbrook explains the strategy this way: Richard can sell sufficient shares in his company to the management team to take full advantage of his \$750,000 lifetime capital gains exemption. This will give

the team a financial stake in the success of the business. As for the rest of Richard's shares, he can exchange them, on a tax-deferred basis, for preferred shares with a fixed dividend yield. These preferred shares will be frozen in value so future business growth will accrue to the management team.

The company will then buy permanent life insurance on Richard's life that will be sufficient to redeem his preferred shares after he dies. Specifically, upon his death, the company will receive the insurance proceeds as the beneficiary of the policy. The company will then use the cash to buy back the preferred shares owned by Richard's estate or heirs.

What does all of this accomplish? First, Richard can utilize his lifetime capital gains exemption, saving about \$175,000 in taxes. He'll defer the tax on the remaining

shares (the preferred shares) until his death. Richard will receive dividends on the full value of his preferred shares while he's alive, which can result in greater retirement income than a full sale of shares today.

As for the management team, they can purchase the company for a lower amount than if they had to buy Richard's shares today (essentially financing the purchase through dividends paid to Richard and the cost of insurance on Richard's life).

Finally, it may be possible to structure the redemption of Richard's preferred shares as tax free in the hands of Richard's heirs through the insurance proceeds and the company's "capital dividend account."

By the way, this insurance strategy can work if you're selling to family or third parties as well.