



Raising Estate Capital from Corporate Assets

a) Reasons to Need Capital

The Business Owner’s Exit Strategies section introduces some of the reasons why capital may be needed when an owner exits the business. While this section concentrates upon the need for capital at death, or in the estate, retirement and disability present similar problems. In all these circumstances capital may be required to:

- Pay capital gains tax.
- Fund partnership buy-out.
- Equalize estate values between children who will take over the business and those who will not.

b) Tax Impediments to Using Corporate Assets

Non Active Business Income Tax Rate

Assets can be accumulated by contributions from the low corporate rate on active business income. However, investment earnings on assets put aside for this purpose will be taxed at an extraordinarily high rate. While some of this rate is a refundable tax, refunded when sufficient dividends are paid out, it does reduce the compounding effect of investment earnings.

Tax on Liquidation

When assets are liquidated there may be taxes on either or both capital gains and recapture of depreciation. This means that more assets than required to make the net payment may have to be liquidated so the company can afford to pay taxes first.

Tax When Paid Out of Company

Generally, when assets are paid out of a company they are subject to a tax. To shareholders that tax will often be a tax on a dividend. A dividend payment is a non-deductible payment by the company. After calculation of the dividend tax credit, the personal tax on the dividend still extracts about 1/3 of the payment in tax. Therefore, for each \$2 of capital the company will need to pay a total dividend of \$3. One dollar is paid in personal tax leaving \$2 as capital.

Dividend paid	\$1,500,000
Personal tax on dividend	500,000
Net proceeds	1,000,000
Capital required	1,000,000
(to pay capital gains tax, fund a buy-out or as an equalization payment)	

Therefore, the company needs to accumulate 50% more than is required after paid out to shareholders

Alternative Tax Planning Techniques

We are aware of many alternative tax-planning techniques to try to avoid the payment of tax on the dividend. Without an extensive discussion on this, it can be said they merely shift the tax burden or defer it to someone else. The tax remains payable.



c) Funding Alternatives➤ **Liquidate Assets**

We have mentioned many of the drawbacks to this option including taxes and auction sale prices. This option may also deprive the business of its operating assets which may end up destroying the business itself

➤ **Create a Sinking Fund**

This is an option many entrepreneurs are not willing to take, as it requires putting aside cash into passive investment assets that are not available for the business. These assets must always be liquid so they cannot be used in the normal course of business. This solution also presupposes there is sufficient time to accumulate the funds and death or disability will not occur prior to that time.

➤ **Borrow**

The most likely outcome may not be possible. Unless credit lines remain free, the ability to borrow a substantial amount at a possibly difficult time in the business' history (it has just lost a principal owner) could be difficult. It is also presumed the interest is deductible, but new guidelines published by CCRA may limit the deductibility of such a loan if used to pay a dividend. This also is the 'default' option if no planning takes place.

➤ **Purchase Life Insurance**

This is not an attractive option for many, as it seems cash is being put aside into 'dead' assets. In fact, it is the least expensive method. One of the reasons for this is that life insurance can provide the required capital to the company in a manner such that it can be paid out tax free. Therefore, only \$1 is required for each dollar of capital required, not \$1.50. This means less needs to be accumulated.

d) A Comparison

The major difficulty in any comparison is that each of these events takes place at a different point in time. Liquidation does not take place until the cash is required. Borrowing only takes place when the funds are required and will be paid off over the following few years. Life insurance requires an active decision to purchase today and any savings plan requires a similar decision.

To overcome the timing issue our comparison will include a Present Value calculation. This is simply a method to bring the comparison to one point in time – now. It establishes the single deposit required to pay all of the costs as they come due assuming the single deposit will earn interest at a specific rate.

However, equally important is the annual cash flow required to pay the costs as this will determine the relative strain on the business operations when the event takes place. This inevitably gives way to the total cumulative after tax cost of each solution.

Case Study

In our comparison we will assume a 50 year old business owner has a requirement for \$1,000,000 of cash outside of the company. Whether the \$1,000,000 is to pay capital gains tax,

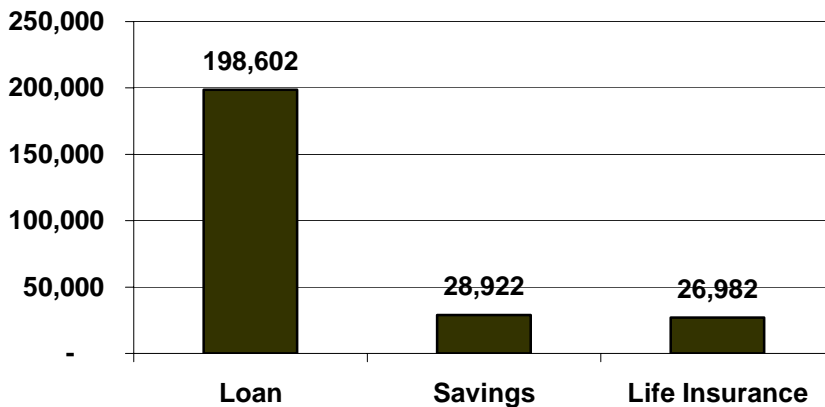




fund a buy-sell or equalize estate values among children is irrelevant. We will assume it is required when he is age 80 – thirty years from now and approximately his life expectancy. We will also assume a tax rate on a dividend of 33%. Our loan interest rate will be 7%, which will be deductible at a rate of 45%. Our savings rate will be 6% taxed at the corporate rate of 45%.

	Dividend Required	Annual Cost	Total Cost	Present Value of Costs
Liquidation	1,492,537		1,492,537	480,541
Sinking Fund (30 years of payments)	1,492,537	28,922	867,660	509,363
Borrow (Repayment over 10 years)	1,492,537	199,602	1,996,020	449,103
Life Insurance (Paid up in 10 years)	1,000,000	26,982	269,820	220,492

Annual Cost Comparison



Present Value of Costs

