

Often overlooked

Preparing for business retirement

By PETER MERRICK
and TREVOR PARRY

Some entrepreneurs may feel secure that their personal financial planning efforts are adequate, but in too many cases the business owner has prepared for his/her personal retirement, but not the retirement of his/her business.

Exiting the business, if not adequately prepared for, offers to many unwelcome surprises made worse by shocking and often unnecessary tax bills.

When asked on how they plan to fund retirement most business owners answer that the sale of their

business will fund the vast majority of their retirement needs.

Too often we find that the business owner is an expert on how to build a business, but a complete neophyte on how to exit it.

Canadian business owners still believe that the buyer of their enterprise will buy the shares of the corporation.

Therefore many still believe that they, and their family members, will all be entitled to a \$500,000 lifetime capital gains exemption for the sale of shares of a qualifying Canadian small business corporation.



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This perception is quite often a mistaken assumption. Currently the vast majority of Canadian small businesses valued at less than \$10 million are not sold pursuant to a share sale, but rather by a sale of the business assets. This is particularly true of franchises, the sale of which is rigorously described in the franchise agreement.

Asset sales result in income being generated within the corporation. This can lead to much higher tax bills than were expected.

For instance if a business sells for \$3 million pursuant to a share sale the shareholders, in most cases, will enjoy a \$500,000 capital gains exemption and tax on half of the remaining gain, which should equate to tax at between 23 per cent and 35 per cent. Therefore a small business, the shares of which are owned in equal amounts by husband and wife, would see tax on \$500,000 each, generating a total tax bill of approximately \$464,000.

The asset sale generates a much larger tax bill. There is no \$500,000 exemption in asset sale

transactions, and as such the entire sale amount is treated as income. The traditional advice to the business owners is to bonus out the proceeds of the sale, pay the tax and invest safely to ensure a robust retirement. That payment of bonus will attract personal income tax, and in many provinces a provincial health care tax.

In Ontario, the payment of two \$1.5 million shareholder bonuses to our two principals will generate an Ontario employer health tax of \$58,500, which must be paid before the individuals receive bonus payments.

The remaining amount will be paid out in two payments of \$1,470,750 which will generate a tax bill to each shareholder of \$665,693 or \$1,331,386 in total. When faced with this potential bill most business owners are understandably irate.

Is there a means of reducing this tax? The answer, fortunately, is 'yes.' The resolution of this problem does not require an understanding of rocket science, or a precarious interpretation of income tax which invites that unwelcome Canada Revenue Agency knock on the door.

In fact, the structure that can turn the tables for Canadian business owners emanates from the pages of the governments own play book; that is, the *Income Tax Act* s. 248 (1).

Designed in 1986 as an anti-avoidance measure, the retirement compensation arrangement can, in most cases, radically reduce the overall tax paid on an asset sale of a business.

It does so by postponing the date on which final taxes are paid.

It makes time and flexibility an ally of the business owner, thus allowing for future tax planning by deferring and controlling distributions of income to future years.

Let's look at our previously mentioned case. How can the business owners facing a \$3 million asset sale utilize an RCA to reduce overall taxation? Before any structure can be implemented the contributions that the company is going to make to the plan must be reasonable in the eyes of CRA.

A recent tax ruling from CRA stated that using an actuarial valuation goes a long way to establishing reasonableness. In our case we were able to use \$120,000 as the income average over a 30-year employment history to establish the limit for contribution at \$3.01 million for our two business owners.

This meant that virtually all of the proceeds of sale could be contributed to the RCA. The immediate tax due on the sale had thus been postponed.

The RCA is a trust which will receive one half of the total contribution. The remainder will be held by CRA in a refundable tax account which pays no interest. The trust is responsible for filing an annual return to show deposits, withdrawals and investment returns.

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Too much talk, too little action

By PAUL TYERS

With the year having come to a close we often hear about year-end tax planning. However, there is a whole lot more talk than action.

Waiting until March or April of the following year to start thinking about tax planning is unacceptable, but it happens all the time.

This happens either because people wait until it is too late to start or because of the chain of events that is to follow. Accountants, for their part, often don't have the necessary information available in November and December.

But tax planning that truly helps the client should be a joint effort by the parties involved who possess the information.

Clients see their accountant as their primary tax advisor. This means that not only do clients want their accountant to complete their tax returns; they also, and more importantly, want their accountant to be proactive in the search for tax saving vehicles

throughout the year. Accountants who believe tax planning is a year-round occurrence will be able to take advantage of this expectation, which will in turn lead to increased client satisfaction and profitability.

I would like to spend the rest of the article on some basic tax planning tactics.

Using up your clients RRSP contribution room for the year as soon as possible is the bare minimum you can do to minimize tax for the year.

One way to achieve this, if self-employed, is to increase earnings withdrawn from the business so they will be able to maximize RRSP payments.

But what can you do once that is accomplished? There are simple steps which can be taken.

- If the portfolio is mostly interest income, consider restructuring to include more dividend income and capital gains.
- If they have outstanding debts consider liquidating some investments to pay the debt. Then re-

borrow to repurchase other investments. The interest payment will become tax deductible.

- Apply to split CCP benefits between spouses.
- Donate securities to charity. The donation will create a tax credit and any capital gains will have an inclusion rate of 25 per cent.
- Consider making the beneficiaries of a family trust pay tax on income.
- Use capital gains and losses to reduce taxes owed for the year.

Another tax planning tool relating to business owners is the use of an individual pension plan. Contributions by a business into an IPP will be tax deductible and taxable income may be reduced to the small business rate.

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