Planning & Insurance - Summary Notes

Mon, Nov 25, 2019 at 10:58 AM

Good morning John & Terry

Thank you again for taking the time to meet last week. I really enjoyed our conversation and look forward to sitting down with you again in the near future.

The purpose of this email is to summarize (in detail) our conversation. For me, this email is essentially my notes from the meeting and what I will refer back to in future conversations. I apologize for the length, but I hope you find great value in the message.

Corporate Structure

The primary focus of our conversation was to explore how a revised corporate structure could help you achieve your succession planning goals. You wanted to understand more about how a family trust worked and where it may fit in your planning.

Below is a list of planning goals you shared with us during our meeting:

1. You wish to gift/sell shares of Opco to your son-in-law (Ed), who has been instrumental in building the business to what it is today. Ed is vital in your succession plan.
2. You plan to add two of your sons, possibly three to the ownership structure in the future.
3. You wish to have the family maintain control of the company into the future.
4. Two of your children have been working in the business and another recently joined. The other 3 children will not work in the business. Equalizing the value of the estate amongst all children is a primary planning concern.
5. Provide an opportunity to gift money to children during yours and Jackie's lifetime.

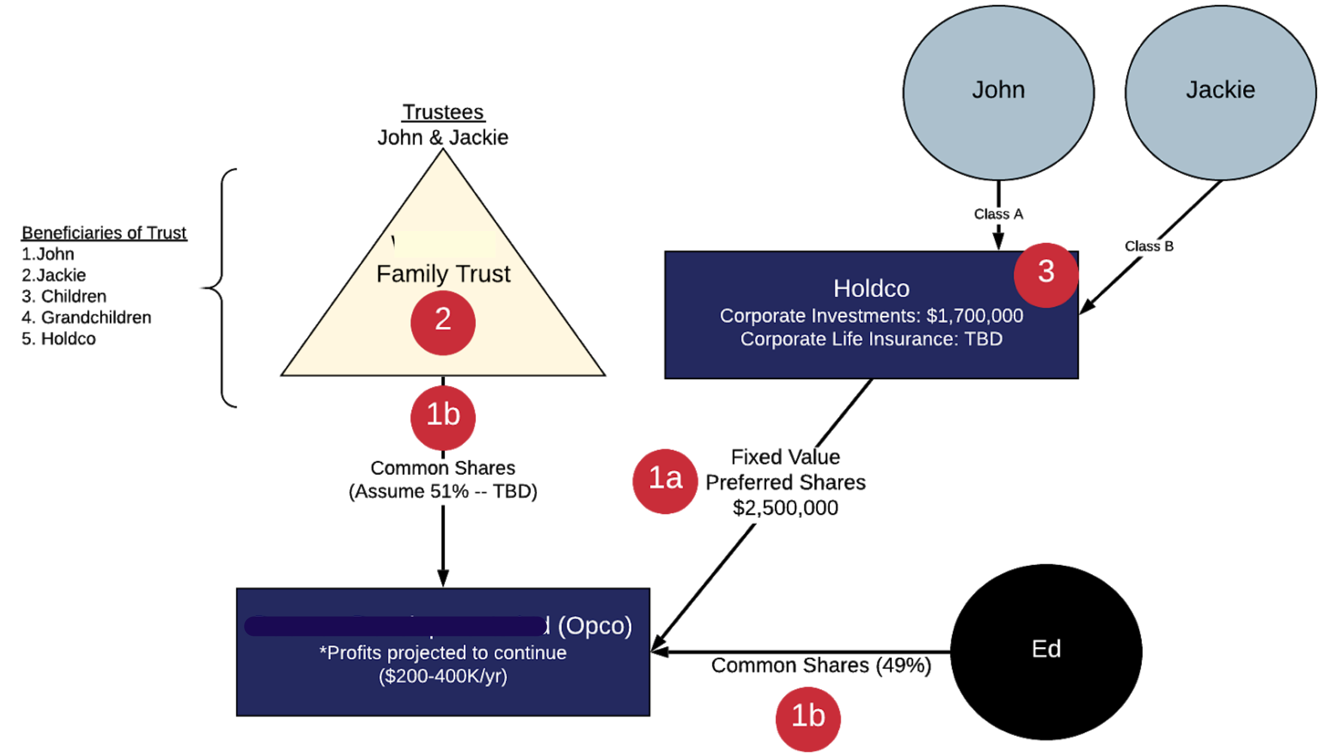
From a planning perspective, I have added some additional goals below:

1. Ensure tax-efficient retirement income for John and Jackie for life
2. Ensure the passive tax changes from 2018 do not come into play on the $1.7M of cash/corporate investments that have accumulated. This new tax can impact the small business tax rate on the OPCO.
3. Ensure the $1.7M of cash/corporate investments avoids passive income tax rate of 50.17%
4. Ensure future growth of the company can be achieved tax efficiently
5. Reduce estate tax (47-73%) and maximize what goes to your family

<u>Disclaimer (of course!)</u>

To simplify the explanation of how a restructure might work, we will use images/graphs that are for illustrative purposes only. These images/comments should not be considered tax advice. They are intended to help you better understand "why" certain aspects are recommended. We will rely on your tax professional (Andrew Walker, CPA) to recommend the most appropriate structure given your situation.

<u>Example Corporate Structure</u>



In order to bring in Ed (and others in future) as a shareholder, the value of the OPCO needs to be "frozen". The "frozen" value belongs to you and Jackie in your HOLDCO, and any future growth can be allocated to your successor(s) eg. Ed and a family trust. If we move the $1M in cash from the OPCO to the HOLDCO, the OPCO valuation will be approximately $2.5M. We also estimate excess profits to be $500,000 per year. In the chart above, it shows an example of a new structure, refer to the red circles labeled "1a" and "1b":

- **1a** - Instead of Holdco owning $2.5M of common shares, you've exchanged those common shares for preferred shares. Preferred shares are equal to the FMV of the company, and they generally have no voting rights.
- **1b** - All future growth of the company passes to new common shares. In this example, 49% of the common shares are sold to Ed, and your family trust owns 51%

The above structure would allow future growth to accrue to a family trust with the potential to claim the capital gains exemption by each of the beneficiaries of the trust on a future sale. Without getting into detail, the value of Holdco is approximately $4.2M (the valuation includes the cash in Opco). That leaves an accrued tax liability of approximately $1,000,000 and will continue to grow as the Holdco's assets grow.

Why a family trust? (red circle #2)

The family trust can accomplish the following:

- Future growth of the company is kept in-the-family (51%).
- If you (John) are the trustee of the trust, you maintain control of the Opco
- If the company continues to increase in value (which creates future capital gains), those gains can be eliminated by using each beneficiary's (ie. Your children/Jackie, etc) capital gains exemption
- You can choose to pay dividends to beneficiaries of the trust in your lifetime. For example, you can pay a dividend to each of your children (they must claim the dividend on their personal return(s)) -- your accountant will have to explain 'TOSI' rules to you (save this for another day).
- You can also pay a dividend to your Holdco (so you can save more money in the Holdco (if you choose)

A family trust accomplishes 3 of your 4 goals (#1, 2 & 4). It also accomplishes goal #4 from the planning list.

Holdco Planning (red circle #3)

You have $1,700,000 of cash/investments in your Holdco (I realize there is $1M of cash in Opco, but it will be moved to Holdco). We want to avoid passive income inside of the corporation as it is currently taxed at 50.17%. Passive income is most often income from property (ie. rental income, interest income, taxable capital gains, etc.). It doesn't help that the government will start clawing back your small business tax rate once you start earning more than $50,000 of passive income each year.

Two common ways to avoid passive taxation are:

1. Use corporate class investments that defer tax or invest in securities that earn capital gains or eligible dividends. This will facilitate the payment of non-taxable dividends from the corporation to its shareholders through what is called the Capital Dividend Account.
2. Use cash value life insurance. Corporate investments within a life insurance policy grow tax-free.

Corporate Life Insurance (Holdco)

The cash value in a life insurance policy is low risk (ie. fixed income) but the growth is entirely tax-free. It is not considered passive income, so it avoids the 50.17% tax. Life insurance provides significant guarantees which are not offered by other investments, and there are strategies to get access to this money for income-purposes tax-free (it's called an 'Insured Retirement Program'). We'll talk about this in a future meeting.

For your situation, there are two needs for life insurance:

1. Current estimated tax liability of $1M on death of the second spouse
2. You have a desire to equalize the estate for your children

At second death, there are three different tax events (for the Holdco - assume the beneficiaries are your children equally):

1. Tax on the shares of Holdco
2. Tax on the deemed disposition of the investments within Holdco
3. Tax (~47%) when beneficiaries take the money out of the corporation (usually upon wind up)

Life insurance helps eliminate/significantly reduce the tax in point #3 (accountants have strategies for point #1).

For example, let's pretend you and Jackie died yesterday. The value of Holdco after restructure is $4.2M (investment portfolio of $1,700,000 plus your preferred shares of $2.5M). At death, your children will wind-up the company and remove these assets from the corporation (for their personal reasons/spending). Each will take a non-eligible dividend from the corporation (~$867,000) and pay personal tax at 47%. That means they each receive about $430,000 net tax.

Instead, if $4,200,000 was paid as a death benefit into the corporation, it would create a capital dividend account *("CDA") credit of $4,200,000 (the actual math is more complicated depending on the product, but this is just an example). Capital dividends are paid to your children (instead of non-eligible dividends). Capital dividends are taxed at 0% (instead of 47%).

Life insurance is a great estate planning tool for corporations because of the capital dividend account.

<u>What Now?</u>

I hope the above explanation helps simplify some very complicated stuff. Here's a list of the next steps:

1. Proceed with the reorganization with Andrew at RBW and Harold Olij. We will work with Andrew to ensure that we are all focused on the same results.
2. Open an investment account for your HOLDCO with Terry Lynn to prepare for the movement of funds from cash/savings accounts.
3. We will build some retirement income projections to illustrate the source(s) of your retirement income. We will also create some estate projections. Preparing these projections will assist in identifying problems and opportunities in the future. It also helps to ensure that any product recommendations going forward are suitable. At that point, we will request another meeting with you to present our findings.
4. We should apply for life insurance for you and Jackie. You will have an estimated tax liability of about $1,000,000, and we will want to use insurance as a tax planning tool for retirement/estate. The application process can take several weeks (probably taking us through the new year). Ideally, we can get the medicals completed so we can implement recommendations in the new year. Once we have confirmation from the insurance company, we can finalize the amount of coverage as well as ownership structure.

<u>Other considerations:</u>

- RSP room $217K if required to facilitate restructure or to shelter 2019 bonus
- Ed should be brought in to discussions soon to ensure that he is on board
- Buy-sell agreements and funding in the event someone gets sick, disabled or passes away
- Shareholder agreements will need to draft up as soon as possible
- Wills (including secondary) for everyone

Thank you again for your time. Please email or call if you have any questions.

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