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IS IT TIME TO REORGANIZE YOUR CORPORATE STRUCTURE?

When most new business owners initially incorporate, the structure of their company tends to be very straightforward; the owner owns all the shares. It's an approach that keeps costs low and is easy to administer. However, as the business grows, that structure may not provide all the tax benefits available to the owner. Reorganizing may be a smart decision for a number of reasons:

Succession Planning

Succession planning is the process of making sure the business continues after the current owner/manager has retired. Businesses can be passed on through transfer to family members, sale to key employees or outright sale to a third party. Reorganization can be useful in all three of these scenarios, and is an effective tool to ensure the owner's goals for business continuation are achieved:

- It can fix the price the next generation of family members would pay for the business.
- Key employees can be made shareholders while the owner/manager is still involved in the business. The employees will be tied to the business through ownership and come to understand the responsibilities that are involved in being an owner, but will still be able to benefit from the owner/manager's experience.

Capital Gains Splitting

One of the most significant tax benefits for business owners is the Lifetime Capital Gains Exemption. It allows an individual to shelter up to \$750,000 on the sale of qualifying shares of a private company. As a company grows in value beyond this amount, the owner should consider additional owners such as

spouses and family members so that the potential is there to use more than one \$750,000 exemption when the company is ultimately sold.

If an owner does not want to provide direct ownership of shares to certain family members, a discretionary trust can be established. The owner then acts as trustee to control the shares, allowing spouses and family members to have beneficial ownership of trust assets without direct ownership.

Capital Gains Exemption

When the shares of a private company are sold, specific criteria must be met to qualify for the Lifetime Capital Gains Exemption. For one, substantially all of the assets of the company must be used in the business. If the company has accumulated assets such as investments, properties or surplus cash that are *not* used in the business, the shareholder may not qualify to use the Capital Gains Exemption, or may incur significant tax costs to remove the offending assets.

With a reorganization, these assets can be removed from the operating corporation without being subjected to income tax. (To be eligible for the tax relief, the reorganization must be completed before a sale is even contemplated; the standard is at least two years before the sale.) Removing these assets also reduces the complexity of the sale transaction, and a "clean" balance sheet can make the business more appealing to buyers.



Creditor Proofing

Should the operating company fall on difficult times or be sued, its assets would be exposed to creditors. However, a reorganization can allow surpluses to be transferred, tax-free, to an independent holding company, where they are sheltered from creditors of the operating company.

No two businesses are the same. Each owner has different long-term plans for the success of his or her business, and only those plans will determine the appropriate structure of the business. The sooner that structure is put in place, the more effective it will be.

If you have questions about this article, or would like to talk to us about your corporate structure and how it relates to your long terms plans, please contact us. We would be happy to help you determine what types of structural changes would benefit you and your company most.

INVESTING SMART IN TOUGH TIMES: WHAT YOU CAN DO WHEN A BUSINESS FAILS?

In this turbulent economy, failed businesses are an unfortunate fact of life. If you have invested in a company that has become insolvent, you may be eligible for one of two types of tax relief:

- a) **Capital Loss:** When you buy shares or loan funds to an operating company, any loss that occurs is generally considered a Capital Loss. It can be applied to reduce the declared gains from the sale of other investments (such as publicly listed shares or real estate). However, the tax benefit is only available if there has been a capital gain realized from the sale of those other investments. A capital loss can be applied to capital gains realized in the prior three taxation years, or can be carried forward indefinitely to reduce future capital gains.
- b) **Business Investment Loss:** If you have invested in a private Canadian company (and certain other criteria have been met), your loss may qualify as a Business Investment Loss. Unlike a Capital Loss, it can be applied to reduce your declared income from other sources, reducing your income tax in the year the claim is made. If the loss exceeds your income in that year, the amount can be applied to the prior three years' income, or it can be carried forward to reduce declared income in the subsequent ten years.

Timing is Important

To claim the loss in a taxation year, you must sell or dispose of the shares or debt. Since there is a limited market for the

shares and debt of a private company, finding a third party buyer is unlikely. Alternatively, if the underlying company is insolvent, an election can be filed to sell the shares or debt at your year end. Timing is key; to be considered a Business Investment Loss, the investment must be disposed of within 12 months of the company ceasing active operations.

Documentation

The tax advantages of making a claim for a defunct investment can be significant. Make sure you have documentation to support your original investment, as the CRA will likely review the claim. (Because private companies usually focus their resources on operations, they tend not to be great at informing investors about the status of their investment. There have been cases in which passive investors could not provide evidence of payment or prove that the shares or debt existed, and so they were unable to claim the loss).

Future Investments

When investing in a private company, most people go in with a sense of excitement and optimism – after all, why invest in something that won't make a profit? However, the reality is that most new businesses fail. Your best bet is to hope for the best, but plan for the worst. Get the documents you need at every stage, and arrange your investment so it qualifies as a Business Investment Loss should the company fail.

If you have invested in a private company that has become dormant, or you're not sure of the status of your investment, monitor the investments and review your documentation so a claim for tax relief can be made.

If you have questions about Capital and Business Investment Losses, or you would like to review the status of any of your investments, please do not hesitate to contact us.



KEEPING THE PEACE AT THE TOP: HOW TO PREVENT SHAREHOLDER DISPUTES

When a company has more than one owner, conflicts are bound to occur. Not everyone will have the same vision for the company, and when you're dealing with several personalities – even when they're in the same family (or especially when they're from the same family) – disputes can arise.

What if you want to take the business in a new direction, but the other owners disagree? What if you get a great offer to sell the business, but one shareholder isn't interested? What happens to your company if one of your shareholders declares bankruptcy?

If you haven't considered how you and your shareholders would deal with these scenarios, there's no time like the present for getting things sorted out – *before* they become a problem.

Put it in Writing

You probably don't want to think about what would happen if another shareholder died or wanted to change the company in ways you didn't agree with. In a perfect world, none of those issues would ever come up. But things happen. Issues arise, and personalities and differing priorities come into play. Take the time now to talk about all the possible scenarios together, and put together a written plan that deals with each one specifically so there's no confusion or conflict. Make sure you address the following questions:

- When will an owner be allowed to or required to sell their interest?
- What rights do they have? What are the obligations of the remaining shareholders?
- How will the value of their share be determined?
- What happens if the shareholders can no longer work together?
- What happens when new potential owners are identified?

Keep it Current

As your business evolves, so should your agreement. Make sure you revisit it regularly (we recommend scheduling a review once a year), and update it whenever changes occur in the company through mergers, acquisitions, new partners, changing business environment, etc.). If the agreement ends up going out of date, you may find it is no longer binding when it is actually needed. If legal action is required, the process can be costly and time-consuming.

Determine the Value of Your Business

Agree on a formula to value your business, or determine a method to have it valued when needed. Some owners like to know the value of a company on a regular basis. Reviewing the value periodically will provide a refreshed perspective on the company, and determine where things stand well before a crisis or conflict occurs.

Our accounting professionals would be happy to sit down with you and your partners to determine a plan to protect the future of your company as well as the interests of individual owners.

KEEP YOUR BUSINESS IN SHAPE: TIPS FOR MAINTAINING FINANCIAL FITNESS

A healthy business, like a healthy body, is stronger, more flexible and more efficient. Take a few steps to ensure the fitness of your business by staying on top of things throughout the year, and you'll ensure a healthier financial future.

Collect Your Money

Get in your receivables before the end of the fiscal year; the more you collect, the better your cash flow will be. To make things easier, try to collect as soon as you've made the sale or completed the service. A lot of small business owners are so busy with day-to-day tasks that getting paid actually ends up pretty low on the priority list. Stay on top of things by implementing a strict collection procedure; you'll keep track of your accounts and won't end up scrambling to settle accounts at the end of the year.

Wrap Up Outstanding Accounts Throughout the Year

Follow up on more difficult accounts as early in the year as you can. Implementing a strict collection procedure will help identify problem accounts. If you end up needing a lawyer or filing in small claims court, you probably won't get paid in time to claim the money in your year-end statements.



Facts & Tax

Write Off Your Losses

Don't pay taxes on money you haven't received. If you're not able to collect on an account, or you think it will take a long time to resolve, write it off. And don't forget to recover HST on those receivables. You can do that as part of your regular remittance; just show the amount as an adjustment and your HST owing will be reduced accordingly.

Buy Fixed Assets at the End of the Year

Do you need to acquire equipment, vehicles or space for your business? If you buy at the end of the fiscal year instead of the beginning of the new one, you can claim the tax deduction in the same year instead of having to wait a whole year to claim it.

Don't get Stuck with Too Much Inventory

Keep close track of your stock throughout the year so you can be aware of inventory that's moving slowly. Talk to your supplier about deadlines for returning inventory so you don't get stuck with a store or warehouse full of items you can't sell.

At Hilborn Ellis Grant, we can provide you with the tax and planning strategies you need to help your business succeed.

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