S+C Partners LLP
CHARTERED ACCOUNTANTS

6 Easy Steps to Creditor-Proof Your Business

SPECIAL REPORT

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We meet people like you, successful business owners, everyday with concerns about protecting the value of their largest asset, their businesses. You have worked hard for many years to build and develop a business, hire staff, expand operations, and maybe even purchase a building. You fear that one day through no fault of your own you may lose your largest asset caused by something you have no control over: a natural disaster, information technology failure, customer or employee lawsuits, weak economy, or changes in government policy.

In this special report you will learn how to protect the value of your business in 6 easy steps.

Step One

Review your business' existing liability insurance coverage

It goes without saying that your first line of protection is your business insurance. You should spend time every year to review your existing insurance policies on their anniversary date. Your business insurance policies should protect against liability for bodily injury or property damage caused by your business operations. Equally important is insurance for your business assets: accounts receivables, inventory, and property plant and equipment. Business continuity insurance should be adequate to protect your business in the event of a major disaster. You need to ensure that these policies are up to date and reflect the current revenue levels of the business. The proper advice and counsel of a licensed broker is required. A liability claim in excess of your insurance coverage could result in a new and unwelcomed creditor to your business.

Step Two

Incorporate a holding company (Holdco)

To protect your equity in your company you need to move it to a Holdco. The Holdco, a new company, can be incorporated electronically with the touch of a button and the payment of a fee ($360 in the province of Ontario). Your new Holdco will become the ultimate shareholder of your business, and that is why we refer to it as a Holdco. Use the services of a professional lawyer to do this correctly. We meet business owners that have incorporated their own companies to save professional fees only to have to pay lawyers to file articles of amendment to fix their errors. Do yourself a favour too and name that holding company (small additional fee for a name search).

A company's articles of incorporation should permit multiple classes of shares issuable in series and some that have estate planning attributes like a fixed value preferred share with a discretionary dividend entitlement and retraction and redemption features.

FIGURE 1

Mr. Jones owns 100% of Jones Co. Mr. Jones also owns 100% of Jones Real Estate Co. Mr. Jones then incorporates Holdco.

Step Three

Transfer the ownership of your business to the holding company on a tax deferred basis

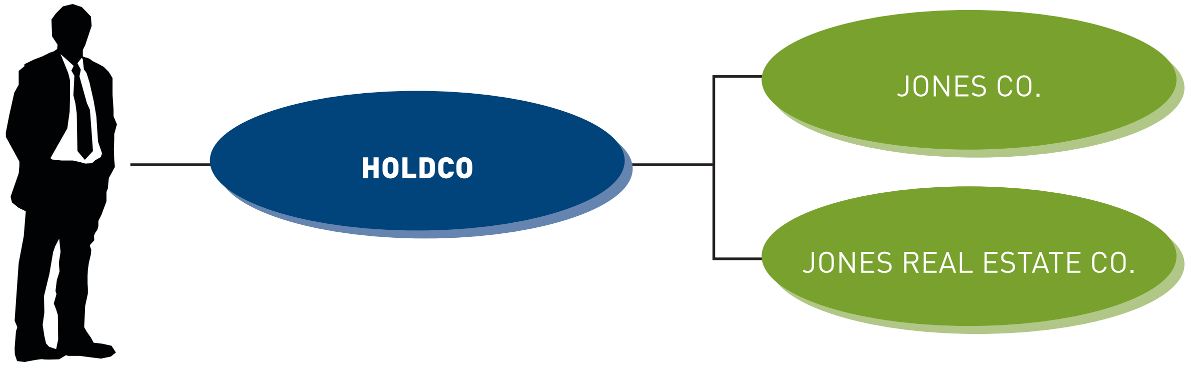
Step 3 involves moving the value you own in your business to the holding company. You must take care to ensure you comply with Canadian tax laws; otherwise you might end up with a significant tax liability. Canadian tax laws allow you to file a rollover election (Form T2057: Election on disposition of property by a taxpayer to a taxable Canadian corporation) that permits you to exchange your shares in your business for shares of equal value in your existing business or in your new holding company.

The key to keeping the transaction tax-free is that you must take back shares as consideration for the shares in the business that you are giving up. You will need the help of a lawyer to update the corporate minute books of both the business and Holdco and also to draft a rollover agreement. A properly drafted rollover agreement will address the interests being exchanged, the value ascribed to them, and the other basic terms of the transaction.

A key part to this transfer is that the business being transferred needs to be properly valued. This valuation requirement is to ensure the shares received have equal value to the shares given up. The valuation does not need to be a detailed and expensive valuation opinion prepared by a Chartered Business Valuator but it does need to be a reasonable attempt at properly valuing the business and its assets including goodwill. The tax rules in the Income Tax Act are designed to discourage improper valuations with damaging results.

FIGURE 2

Mr. Jones exchanges 100% of Jones. Co. and 100% of Jones Real Estate Co. in exchange for shares of Holdco



Step Four

Pay a tax-free intercorporate dividend from your business to Holdco

The exchange of your business shares for shares of your Holdco does not move any value out of your business. To protect your equity you have to move the retained earnings to your Holdco via a dividend.

Dividends paid between connected corporations flow tax free. The key to having corporations connected is to have greater than 10% of the business owned by your Holdco. The dividend paid will reduce the retained earnings in your business, but cannot create a deficit, and increase the retained earnings in your Holdco. Under corporate law, a dividend may be paid only where the business is not rendered insolvent after the payment of the dividend.

The purpose for Holdco is to defer the incidence of personal tax that would arise if a taxable dividend was paid from the business to yourself. This tax savings could amount to be 33% of the value of the dividend paid.

Step Five

Create a general security agreement between your business and Holdco

While it may be possible to pay a large dividend to Holdco out of the business because of many years of accumulated earnings it is reasonable that those retained earnings are supporting your banking relationships and how you finance your business. Paying a dividend that reduces your retained earnings to a nominal amount, more often than not, puts financial stress on your business. After paying the dividend Holdco, and to the extent necessary, Holdco should lend the funds back to your business and secure the loan.

In the province of Ontario, the general security agreement is registered under the Personal Property and Security Act of Ontario for a fee. The fee is dependent on the length of registration. You should consider at least a 5 year registration period.

As a secured lender, Holdco may lend monies to your business at interest to allow it to meet the cash flow demands of your business. To create this secured relationship you need to come to an agreement about what the security pledge by the business to Holdco might look like, thus the general security agreement. We refer to a general security agreement because if you are interested in protecting your business you want to get security over everything you can lay claim to including tangible and intangible property. A properly drafted general security agreement will set out the terms of the security being offered by your business to Holdco. Proper legal counsel should be sought for assistance in drafting this agreement.

It is likely that your business has provided a general security agreement to your bank. The general security agreement that you put in place for Holdco will need to be postponed to the bank's position. We refer to this as a second ranking security interest. In our view, your banker will see these creditor proofing transactions as evidence of good corporate governance.

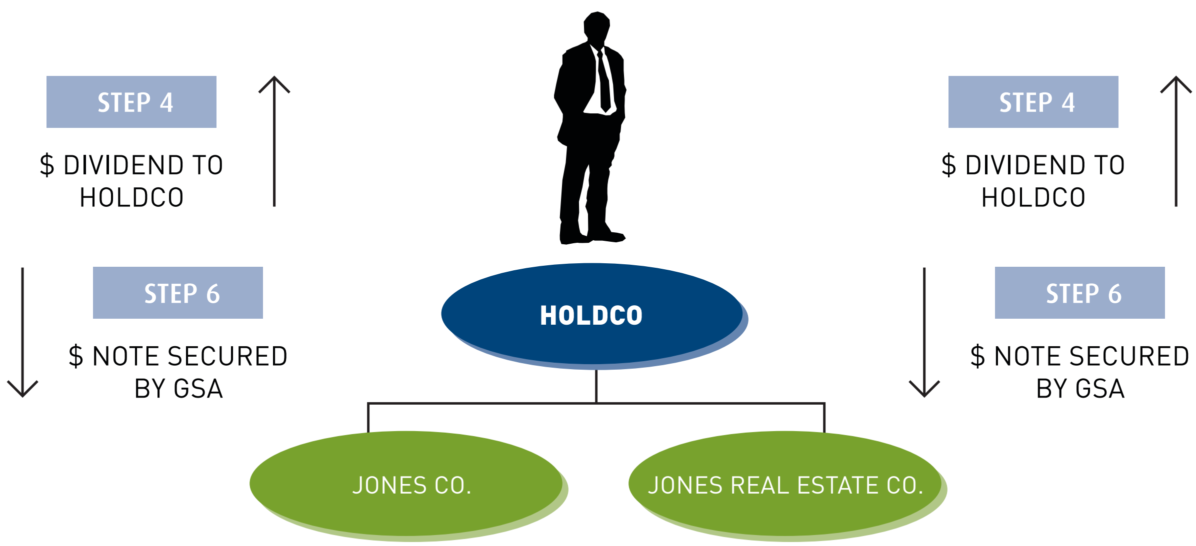
After registration, the security interest will be highlighted when a corporate search is performed on your business.

Step Six

Holdco lends money to the business

The act of lending money to the business puts Holdco into the position of a creditor. With a properly registered security document Holdco has become a secured creditor of your business that ranks in priority to the claims of unsecured creditors and in many cases, statutory liabilities excluding payroll deductions.

Retained earnings of your business rank as the lowest creditor in your business. You should pay dividends on an annual basis to your holding company and lend the funds back each year. This keeps all your equity protected. The loan to Holdco can take the form of a promissory note at interest. We recommend you consider a grid for the promissory note so that it can be updated as payments are made and new loans advanced or previous ones retired.



That's it. Your Done.

You can now take comfort in the knowledge that you have protected the retained earnings in your business that you left behind from many years of hard work. You know that your insurance coverage has been reviewed and updated with your insurance broker. You also know that your solicitor has updated the corporate minute books, registered security, not paid one additional cent of income tax as a result of these rollovers and transactions.

Safe in the knowledge that the business is in better shape you may now turn your mind to income splitting and ways of introducing other shareholders into the share ownership of Holdco to maximize the after tax cash flow of the business' earnings to the family unit.

About S+C Partners LLP

S+C Partners LLP has the experience to help you evaluate your options and determine the right succession planning strategy for your business. We can help you get the process started with an introductory meeting scheduled at your convenience.

S+C Partners LLP provides first-class assurance, taxation and advisory services to successful enterprises to support their financial commitments and minimize tax liabilities.

We carry out our mission by providing our clients with timely, top-notch professional services throughout the year. S+C has recruited, developed and trained a first-class client service team to respond on a timely basis to requests for a broad range of professional services.

Based in Mississauga, Ontario, S+C has operated with the same core values of client focus, trust, teamwork, and excellence for more than 20 years. Today, S+C is led by a number of Client Service Partners, who are recognized leaders and specialists in their field. For more information on S+C Partners LLP, please call (905) 821-9215 or toll-free 1-866-965-1435 or visit us on the web at scpllp.com or email info@scpllp.com.