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Planning and guidance help take advantage of incredible tax break on capital gains

By DON NILSON, CMA, FCMA

Entrepreneurship at the next level

All entrepreneurs face an over-filled list of to-do's in aspiring to keep their business functioning at a high level. Inevitably, some of those to-do's don't ever seem to get done, and long-term planning is frequently on that list! Also, entrepreneurs can be victims of the "cobbler's kids" story, where the last thing to get done is taking care of oneself!

Entrepreneurs who are running long-term, successful businesses need to keep an eye on the horizon. The popular business press is rife with stories about the massive number of small businesses which will be facing some form of succession in the near future, as the founders prepare to retire. Advance preparation for this eventuality is important, and that includes tax preparation.

Our tax law contains a very generous and valuable tax break for entrepreneurs when they sell their companies. It is the last vestige of the 1985 capital gains exemption which, since 1994, is now only available to a small subset

of taxpayers – entrepreneurs, farmers and fishers. This provision allows tax-free capital gains of up to \$750,000, which may be multiplied if there are several family members owning shares in the private business. However, the qualifying rules that permit this tax break are complex.

The business itself must be a "qualifying small business corporation", or QSBC. There are several tests to be a QSBC. One is a quantitative look at the assets of the corporation at the time of sale. Based upon the fair market valuation of the business assets, including implicit



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goodwill, the “operating” assets (as opposed to “passive” assets) must be at least 90 per cent of the market value of the business. There is a second, similar calculation, but it is a “look back” over the 24 months previous to the date of sale. Here, the qualifying ratio is a more relaxed 50 per cent or more. A business preparing for sale can review the first calculation and, if the calculation is offside, some proactive steps can be taken before the sale date closes in order to be onside the 90 per cent rule. However, the past cannot be undone! This means that either a) the \$750,000 freebie would be lost, or b) the business sale would be deferred for two more years, during which time the offending ratio would be managed, going forward.

A second related issue in a successful business is that, over time, the retained profits of the business may be building up as surplus cash. On the other hand, if the business is both successful and growing significantly, the retained profit may not be sitting in a big cash balance but rather may be deployed in financing that growth – in higher receivables, inventory or equipment. But if the requirements of business operations still allow a large cash buildup, the entrepreneur will be looking at that cash balance and realizing that it is earning nothing at the bank. So, other investment opportunities are sought. This is the moment that raises the flag in the entrepreneur’s career! At this moment, his operating business has formally become a defacto ancillary “pension” plan! When that excess cash is deployed to other investment assets, the company starts to run afoul of the 50 per cent and 90 per cent tests.

A year-to-year problem with keeping passive and operating activities in one entity is that the business will pay two different tax rates – a low rate (13.5 per cent in



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Opening Worlds



B.C.) on the active income and a high rate (about 45 per cent in B.C.) on the passive income. The high passive rate is significantly mitigated to the business if dividends are paid out to the shareholder, because this causes a “dividend (tax) refund”. However, the bottom line is that sub-optimal overall tax planning will ensue if this one-company structure is retained long term.

In order to preserve the \$750,000 freebie downstream, the entrepreneur needs to move that defacto pension plan outside of the operating company. This is termed “purification”. There are several ways to do this. The first is conventional – take the money out and invest it personally. This unfortunately probably has a high personal tax cost, if the entrepreneur already has fully used the RRSP contribution room. The second might involve setting up a rich Individual Pension Plan, which can be a one-person customized pension for the owner. However, there are limits to these, which may not suit the ongoing financial success of the business.

The third requires proactivity, and the assistance of professional advice – both legal and accounting. The entrepreneur should contemplate constructing a complex corporate structure where the original operating company (OpCo) is augmented by a new company (HoldCo) which will take over the surplus passive assets which confound the 50/90 per cent test. In brief, the process would include valuing the OpCo shares and transferring to HoldCo the proportion of those shares that equals the proportion of the surplus assets vis-avis the total valuation. The entrepreneur would receive preferred shares in HoldCo in exchange. This step bears no immediate tax implications. OpCo would then subscribe to a class of shares in HoldCo for a subscription amount equal to the surplus passive assets. At this point, the two companies own shares in each other.

The next step is that these crossed shareholdings would be exchanged between the two companies and taken off each set of books. The entrepreneur’s remaining shares in OpCo would then undergo a freeze, exchanging for redeemable preferred shares in OpCo for the residual value. Now, new classes of shares can be issued at nominal value to the entrepreneur and/or the HoldCo. It is desirable that HoldCo indeed receives some new shares in OpCo so that future surplus passive assets can routinely move over to HoldCo as periodic dividends. Otherwise, the above complex purification process would need to be undertaken regularly, at significant professional fees. If instead the periodic surplus passive assets are passed from OpCo to HoldCo only as a loan, then that loan still sits on OpCo’s books and continues to endanger the downstream 50/90 per cent test.

Another issue involves who else might be owners of the new HoldCo. There is flexibility here to meet the suitability of the entrepreneur and the family fact pattern. The entrepreneur and HoldCo may be the sole owners, or perhaps jointly with a spouse and/or children. If the children are “minors” (under 18), a special tax termed the “Kiddie” tax would confound tax planning involving those kids. However, children of the age of majority would be fine. The estate plan



could become slightly more elegant if a family trust was created, with family members being named beneficiaries and the trust owning a class of shares in the HoldCo. This can become useful once the kids reach the age of majority, either to fund post-secondary education or other life-stage expenditures, like a home. Even more elegantly, the new OpCo shares could be owned by the family trust instead of HoldCo, and HoldCo could be a beneficiary of the trust. Lastly, the passive assets accumulating in HoldCo might need a long-term future outlet, by way of the family trust holding a class of shares in HoldCo.

The surplus passive assets that accumulate in HoldCo are free to be invested there in any investment opportunity that exists. When OpCo ultimately is sold, HoldCo would be retained in the family and would be an additional source of retirement income, as the investments therein are managed to produce a retirement cash flow.

This sounds complicated, but with professional assistance it is very doable. Various other complexities may arise as the individual fact pattern varies. ■



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