Beating the taxman

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Forget about the notion that entrepreneurs are lone wolves who shun advice and do everything on their own. That's a myth. In real life, most self-employed business-people rely upon a lawyer, an accountant and a banker to help keep their business on track.

Many entrepreneurs, though, don't realize the importance of signing up yet another key player — an insurance specialist. Albert Luk, a Toronto lawyer who works with many entrepreneurs, says life insurance is like a financial Swiss Army knife for the self-employed. It's a risk-management tool, a way to shelter assets from creditors, and a means of keeping a business in the family.

Luk and other advisers urge business owners to forge close relationships with experienced insurance specialists. You probably won't find this to be a natural partnership, since planning for disability or death goes against the fierce optimism of many business owners. But if you start looking at insurance specialists as strategic resources, and not as angels of death, you may find they can save you money. At the very least, a good specialist can explain, in plain English, all those complicated insurance options that you've never had time to untangle.

Start with basic life insurance. You may already have a policy that pays your spouse a decent amount in the event of your death. If so, that's great — but if you're an entrepreneur who has built a sizeable business, you probably need more. When you die, whether it's because of old age or being hit by a bus, the inheritors of your business will face problems that go beyond heartache. Your death triggers a "deemed disposition" of the business, which means that your heirs have to pay tax on the capital gains that you and the company have (at least theoretically) enjoyed up to that point, even though you haven't actually sold the business.

The tax bill that results can be a whopper. Let's say you start a business at 30 and build it into an operation worth $10 million by the time you turn 50. If you died the next day, says Ted Warburton, a partner with First York Insurance in Toronto, your estate would potentially face a $2.3-million-dollar tax bill, based on the current tax rates on capital gains.

Yes, your heirs could ask the bank for a loan to pay the taxes. But Warburton recalls a case where a 48-year-old entrepreneur died — and the bank promptly reduced his business's credit line by $1,000,000. The lender feared the uncertainties that often follow when the company's founder passes away.

In such a case, your heirs could be forced to scour the business for cash — which is usually tied up in receivables, inventory and equipment. In extreme cases, your heirs might have to sell the business's real estate or negotiate a quick sale of the entire company to raise the money needed to pay the taxman. But a hurried sale could result in the inheritors being forced to dump valuable assets at a huge discount. In the example above, the late entrepreneur's family was forced to sell the business for 50 cents on the dollar. "I've seen businesses that have been crippled by this tax," Warburton says.

If you're in a similar situation, you could avoid these problems by having your company fund a permanent insurance policy that will pay $2.3-million on your death. The premium wouldn't come cheap, at about $20,000 a year, but with this kind of insurance the amount you pay will never increase. Especially if you want your firm to remain in your family's hands, you may find the annual bill (even if it's not tax deductible) to be a low price to pay for a tax-free death benefit. "It will allow the family or heirs to focus their attention on fixing the business, not selling it or drawing cash out at a horrendous time," says Warburton. (In fact, your business's tax bill could be much higher than $2.3 million 30 years from now, based on future growth. Warburton assumes you may look at an estate freeze to lock in the value of your share of the business, and attribute future growth to your children or other heirs — but that's another column.)

Luk says some entrepreneurs may go further and consider a universal life plan, in which the policyholder pays more into the policy than the death benefit requires. This allows you to build a savings component into your insurance, which offers several benefits. If you've maxed your RRSP contributions, for instance, putting funds into your personally owned life insurance policy is another way of accumulating savings that grow tax-free (although your initial contributions are not tax-deductible, as RRSPs are). Better still, should you come out on the wrong end of a bankruptcy or lawsuit, your insurance policy, including the savings component, will remain out of reach of any creditor — unlike your house, bank account, or RRSP.

Now may be a good time to start thinking about such issues. Many forecasters predict a declining economy for 2007. In tough times even healthy businesses can be capsized by the failure of a key customer , and it's wise to lock some assets away. But don't wait till the wolves are at the door before transferring your assets into an insurance policy to keep them from creditors. "You have to do it long before any potential judgment, or it can be unwound," says Warburton. Those who contribute to a universal life policy often put their money into segregated funds, or seg. funds, which are the insurers' version of mutual funds. (The "seg" label comes about because these funds are segregated from the insurer's general funds). Seg funds offer guarantees: no matter what the market does, if you hold on to your funds for 10 years you'll get 75% or 100% of your capital back, depending upon the policy. But guarantees cost money, so most seg funds charge annual fees at least a half a percentage point higher than comparable mutual funds.

Depending upon your circumstances, those higher fees may or may not be worth the expense. Bernie Geiss of Cove Financial Planning in North Vancouver, B.C., argues against investing in seg funds, because the management fees are typically higher than similar mutual funds. Investing in other life insurance policies such as universal life and whole life, which are designed to accumulate cash, have other problems. For starters, capital gains are fully taxable when withdrawn from the policy, unlike capital gains earned outside an insurance policy which are taxed at half your income tax rate. As well, investment options are limited and fees are very high.

Instead, Geiss offers his entrepreneurial clients a different way to buy more insurance for less. Through his formula, the entrepreneur buys a universal-life insurance policy, makes excess deposits to the cash account and borrows back an equal amount, investing the money in activities that produce business income. When the cash value compared to the loan has grown to a sufficient degree, the premiums stop. The loan interest, of course, is fully tax deductible.

This structure can eliminate all net costs and make the insurance program cash flow positive. As usual there are lots of ifs, ands or buts, so you'll need to explore this with an accountant or financial planner at your side.

Since everyone's needs are different, Warburton urges business owners to sit down with an insurance professional to review their coverage and discuss their goals. That way, he says, "you may or may not ever use these tools, but at least it will be a conscious business decision."