

FIVE WAYS TO PAY CAPITAL GAINS TAX

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It's a mammoth enough decision to determine whether the business should be sold or passed on to family members. Whomever takes the lead role, at the point in time that a business is passed to the next generation or other owners, all capital gains taxes are triggered and payable. Now we're talking a potentially *mammoth tax* burden.

Print the one-page table for a side-by-side comparison of your tax planning options.

Approximately 23% of the fair market value of a company, assuming a cost base of zero, is payable in tax at the time the children acquire ownership. For example, a manufacturing business has a fair market value of \$25 million. When the owner sells or passes ownership to his adult children, nearly \$6 million goes straight to the CRA. That can often restrict or confine the business activities, especially if the transfer of ownership takes place suddenly (for example of the sudden death of the owner or key person).

With advance planning, there are a number of strategies available to limit, defer or reduce this tax including capital gains exemption, estate freezes and spousal rollovers. But after those important discussions with a professional advisor, when it's time to plan to pass ownership of the business, I advise my business owner clients of five options when planning for the tax payment: cash, sinking fund, selling assets, borrowing money and insurance. Let's look at them one by one.

Cash

Using cash to fund the tax can be quite expensive. These funds are after-tax dollars, so they have already been taxed at a significant rate. Funds inside an operating or holding company must be transferred to the estate to pay the tax. Those funds can attract additional tax as well.

Cash is king and keeping at least some liquid cash helps a growing business, provides comfort in emergency planning and strengthens the balance sheet which can attract future investment. Allocating cash for tax payments effectively locks it up and any future growth and opportunities the cash could provide are lost forever.

Sinking Fund

A sinking fund is a viable option; however, there are two variables at play. Does the business owner have enough *time* to accumulate the necessary amount? Can guaranteed investments produce *meaningful returns* and liquidity?

Selling an Asset

This is probably the easiest solution, albeit, it can paralyze a business. Typically the most attractive, most important assets of the corporation or family asset base has to be sold first- often the building that houses the business. Sell the building and you may be selling the comfort of having control of your plant or office facility.

Timing, market conditions, and selling costs can add another layer of uncertainty in the asset sale approach.

Borrow From the Bank

As business owners, you probably know this is not a likely option. Most lending institutions are not prepared to lend funds for purposes of paying tax (which clearly does not stay on the balance sheet).

If a key executive or shareholder dies banks become increasingly protective of their positions, and watch succession plans and the new generation of owners more closely.

This is a costly option because the loan must be repaid and interest payments would not be deductible.

Insuring the Tax

Using insurance to pay tax is a cost- and tax-effective approach. A properly designed and implemented insured tax program can provide the funds tax free, at exactly the time required.

The policy can be personally or corporately owned while still providing the funds tax free to beneficiaries and/or shareholders of the company.

As with all life insurance policies, there will be medical underwriting. Even in situations where medical issues are a consideration it is *still* worth exploring the insured tax program.

In a properly designed tax funding strategy, all of the family assets will be passed on to the next generation intact.

Funding the Tax on Death Comparative Analysis



Objective: Produce \$1,000,000 twenty-three years from now, using the most efficient, cost-effective approach.

Assumptions

1. The shareholder is 60 years of age, in good health and a non-smoker. We assume he lives until age 83, 23 years from now.
2. The shareholder will have an expected tax liability on death of \$1,000,000 based on the anticipated value of his shares.
3. The shareholder wants to compare and contrast various financing options to cover the tax.

Use Cash		Borrow the funds by the Estate at death		Save the funds personally now		Purchase life insurance personally now		Purchase life insurance via the company now	
Cash Payment ¹ :	\$1,000,000	Loan Amount:	\$1,000,000	Savings Rate:	4.00%	Face Amount:	\$1,000,000	Face Amount:	\$1,000,000
Deposited in:	23 years	Loan Amortization Period:	10 years	Tax on Interest:	46.41%	Life Expectancy:	23 years	Life Expectancy:	23 years
		Loan Rate:	5.0%	Deposit Period:	23 years	Minimum Annual Premium ^A :	\$21,757	Minimum Annual Premium ^{AA} :	\$21,757
		Annual Loan Payment*:	\$129,898	Annual Deposit**:	\$33,377				
PV Cash Payment @4%:	\$405,726	PV Loan Payments @4%:	\$427,469	PV Deposits @4%:	\$515,714	PV Premium Payments @4%:	\$336,166	PV Premium Payments @4%:	\$336,166
		(assumes loan/pmts begin in 23 years)							
¹ Pre-tax cash payment @ 46.41%:	\$1,866,020	*Pre-tax loan payments @ 46.41%:	\$242,392	**Pre-tax deposits @ 46.41%:	\$62,282	^A Pre-tax premium @ 46.41%:	\$40,599	^{AA} Pre-tax premium @ 15.5%:	\$25,748
ADVANTAGES									
<i>Assumes corporate rate income below \$500,000</i>									
- No insurance premiums or sinking fund required now		- No cash outlay now		- All savings are liquid and available for business "emergency"		- Proceeds and premium are guaranteed - Aligns event and funding precisely - Proceeds are tax free - no tax on income or gain over premiums - Potential creditor proof protection		- Proceeds and premium are guaranteed - Aligns event and funding precisely - Proceeds are tax free - no tax on income or gain over premiums - Premiums cease on death - Can provide for a significant reduction in capital gains tax liability - May provide add'l capital dividend account to survivors - Least expensive funding	
DISADVANTAGES									
- Cash for future opportunity gone - Funds must be liquid and available - Investment volatility an issue		- Cash outlay at worst possible time - Non-deductible interest - Most expensive annual cost - Uncertainty of bank loan terms and interest rate - Collateral requirements tie up estate assets		- Requires funding today - Uncertainty of timing and proceeds if death is earlier than 23 years - All interest is taxable - Most expensive PV cost - Interest rate for savings not guaranteed		- Requires somewhat higher pre-tax cash flow now due to personal rate of tax		- Requires funding today	