



How a Substantial Estate Ended In Debt

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Joe Business 1945-2005

Things were looking good at New Year's 2005 and Joe had the best of intentions. When he retired, his oldest son, John, would have taken over the business, assisted by ABC's two top executives. Joe planned to encourage Don and Liz to stay by giving them equity in the company. His second son, Jeff, would have inherited his cottage. His second wife, Sally, would have stayed in the \$1 million family home.

ABC had a bright future. Worth \$20 million in 2005 and still growing, the company would have supported Joe's aging mother, his handicapped daughter, and ensure that 5-year old Jeremy would have received the best of educations.

Joe had split amicably with Susan, his first wife, eight years before his death. The only obligation he had to her was to keep up payments on a \$100,000 life insurance policy. His second family—wife Sally and his youngest son Jeremy—would be well set if something happened to him.

Indeed, Joe was a wealthy man, who kept all his assets in his own name. In addition to a thriving company valued at \$20 million with a zero cost base, he had \$650,000 in equity in his \$1 million home. The cottage he bought in 1973 for \$50,000 was worth \$500,000 and was mortgage-free. With \$250,000 in non-registered investments and \$125,000 in RRSPs, he was in an excellent position to ensure his life's accomplishments would support the people he loved for decades to come.

But Joe was a busy man with a complicated personal life. That was probably what led to everything unraveling. It wasn't what he did that led to the disaster. It was what he didn't do. He never sat down to systematically go through all his assets and obligations, personal and professional, and make plans for what should happen on his death or retirement. He never really faced the difficult issue of dividing an inheritance between two families, an older family with an interest in the business and a younger family that would never participate in company management but would need the wealth that the company produced.

Successful entrepreneur and family man. A builder and creator who seemed to go through life without making a single misstep.

A millionaire by the age of 40, father, supporter of his aging mother, CEO of the ABC Widget Company with sixteen loyal employees, Joe was loved and admired by his family, business colleagues, neighbors and fellow cottagers. It is a testament to the strength and warmth of his character that Joe's wife and ex-wife walked down the aisle together with his four children at his funeral.

Joe certainly didn't mean to leave behind a terrible mess when he died unexpectedly in January 2005. Now, a year later, everything is pretty well settled and we can make a fair assessment of how well Joe fared with his good intentions regarding leaving other people comfortably off after he was gone.

It's almost hard to believe that his legacy was debt.

When Joe died unexpectedly on New Years Day 2005, his family and business associates soon discovered that Joe had left behind a worst-case scenario.

Joe didn't have a valid will. He made a new will after his 1990 divorce, but never got around to making another new will after he married Sally in 1992. Marriage invalidates a will.

There was no business succession plan and, therefore, no clear direction for his son John to take over the company. No incentives for executives Don and Liz to stay on. There were no preparations for dealing with the capital gains taxes that Revenue Canada would want to collect from Joe's estate before the end of the year. (With a Fair Market Value [FMV] of \$20 million for ABC on the day Joe died, his estate would pay tax on 50 per cent of the FMV at the Ontario rate of 46 per cent.)

Two months after Joe's death, it was clear that ABC was not going to operate successfully without its founder and main driving force. The bank demanded repayment of the \$6 million owing on the company's line of credit. ABC's main supplier took steps to ensure that it would recover the \$2 million owed them.

John, Don and Liz liquidated the company. They sold the building and the inventory. They discounted the accounts receivable. By November 2005, they had salvaged \$10 million, half the value of the company. It had been a fire sale. But the bank had its \$6 million. The creditors had their \$2 million.

That left Joe's estate with \$2 million, 10 per cent of the value of the company. Then the tax bill arrived. It makes no difference to the taxman whether the company was sold for its full value or liquidated for a fraction of it. Capital Gains Tax calculations are based on the FMV on the day before the owner died.

The tax bill was \$4.6 million.

All Joe's hopes for a legacy that would support and employ the people important to him had been dashed. His life's work had been transformed into a \$2.6 million debt owed by his estate.

If Joe had taken the time to plan and organize his affairs and assets, he could have achieved a completely different result.

Joe's situation was a little more complex than most. He had two families, with one set of children considerably older than the other. That's certainly not unusual today, when it's common for people to divorce and re-marry. Nor was it in earlier times, when wives often died in childbirth and men would remarry and have a second family.

A good succession planner would have explored this two-family situation carefully. The only acceptable solution would have been a custom solution because some children wanted to be in the business and other children and inheritors expected a "fair share".

The first thing needed in this case was a valid will accompanied by the appropriate powers of attorney. Joe should have seen his lawyer and set down his goals and objectives, ensuring that his second wife was provided for and making it clear how he wanted his estate distributed.

In this case, an estate freeze would have solved many of the problems created by Joe's unexpected death. In an estate freeze that took place in December 2004, the value of Joe's business could have been set at \$20 million and Joe's common shares exchanged for preferred shares equal to that amount. Joe's shares would have been frozen at \$20 million. Then ABC could have issued new common shares either to his children or to a new family trust. If the family trust was chosen, Joe could have decided later how he wanted the common shares to be distributed.

One clear advantage to freezing Joe's assets at \$20 million is that it would have allowed Joe and his wife to calculate the amount of the capital gains tax and taken steps to have those taxes taken care of.

Joe and his wife were unlikely to have the \$4.6 million to pay the tax when it came due. An insurance contract can be designed to pay those taxes with tax-free dollars. By insuring Joe's life for \$4.6 million, the estate would have enough tax-free money to pay the capital gains tax. The common shares that increased in value with the value of the company would belong to the children or the family trust and would not have been subject to capital gains at the time of Joe's death.

(If Joe planned to leave the company to his wife on his death, the insurance policy could have been a last-to-die policy on both Joe and his wife, allowing the company to pass tax-free from spouse to spouse and later providing tax-free money when capital gains was due.)

Had Joe implemented an estate freeze before his untimely death, the whole series of events of 2005 could have been different. The company managers, with incentive to keep the company going in terms of common shares issued in their name and cash on hand to pay the taxes, would have been in a much stronger position. They could have negotiated with the bank and the suppliers and had a better chance to pull the company through rather than liquidating it.

No matter what happened to the company, Joe's wife would have been better off. If the company survived, she would have shares that she could cash in as needed. If the company did not survive, the estate would not have been forced into debt by the arrival of the tax bill after the liquidation of the company.

As an insurance specialist, I have an honest bias in favour of insurance-based solutions in succession planning. Had Joe come to me, I would have encouraged him to look at a succession planning solution that not only provided enough tax-free money to pay the capital gains tax due on his death, I would also have suggested that he take out an additional \$1 million in insurance with his wife as a beneficiary, providing money that allows her to get through a period of uncertainty after his death without having to look to the company for money.

Joe worked hard to earn his wealth. I think that he should have taken steps to ensure that his wealth went to the people of his choice.

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Dale's note: This extreme situation should be a wake-up call to all of us, if necessary, to put our financial plans in place for future needs.