Creditor Proof Your Business

I want to ask you a few questions about your business.

1. Have you worked hard to build the value in your business?
2. Do you have concerns about credit proofing?
3. Is your current business structure providing the protection you need?

If you answered yes, yes and not sure, keep reading. If not, keep reading anyways.

Building a successful business takes smarts, drive, dedication and a little bit of luck.

The process of building a successful business can take decades. Unfortunately, many owners fail to take the simple steps to insulate this success from creditors.

Attacks from creditors come in many forms. The preservation of your wealth depends on having the right business structure in place to stop these attacks.

Post highlights:

1. Look at potential options for creditor proofing your business and why.
2. Analyze a case study that explores the benefits of a Holdco.

Options for creditor proofing:

Incorporation

This is the most obvious option for most owners. If you operate as a proprietorship or partnership, you're open to attacks. The use of a corporation provides some division between business and personal assets in the event of a lawsuit.

Personal Guarantees

Obtaining credit through your corporation can be difficult until it has been in operation for many years. Unfortunately, this opens your personal assets up to attack should the business have difficulties maintaining the loan. Keep this in mind before you put pen to paper. Consider options to secure news loans against existing assets within the corporation.

Holdco

If your operation if fairly successful, a Holdco can provide another layer of security. Profits from your operating company can be moved to the Holdco, decreasing the ability of a creditor attack on your wealth.

Shareholder Loans

When loaning funds to your corporation, make sure you have an agreement in place. These loans should be secured in a similar manner as any other debt the company holds. Should your company experience difficulties, you now have first right over assets.

Trusts

Due to recent changes to the Income Tax Act, Holdco's have become less advantageous for income splitting. Enter the inter vivos trust. The use of trust allows for more tax planning flexibility while maintaining the credit proofing that you are seeking.

Post Highlight #1 Analysis

As you can see, there are a number of viable options available for protecting your wealth.

The dilemma then becomes, which one is right for you?

This comes down to a couple of factors:

1. Overall value of your company and personal assets.
2. The current structure of your operation.
3. Your plans for the future.
4. The costs associated with a particular option.

Just because a plan includes all the bells and whistles, doesn't mean it is the right one for you.

You need to strike a balance between budget and benefits.

Case Study

Let's presume that you've been in business for a while. You've worked hard and have some cash in the bank. Lastly, you're operations are incorporated.

You don't need the money personally and don't have a need to reinvest in the "active" business operation. You have creditor concerns and want to ensure that your wealth is intact when you decide to retire.

The first two and easily the most cost efficient steps would be paying off debt that you've personally guaranteed and securing your shareholder loan.

Check with your creditor to ensure there are no penalties for early payment. Regarding your shareholder loan, simply contact your corporate lawyer to have a simple agreement drafted to secure these funds.

What is your next step once these two items are taken care of? This largely depends on the current value of the company and your plans for the future.

We will presume the following:

1. You have $200k in excess cash.
2. You own the operating company with your spouse.
3. Your kids aren't interested in the business.

Given the details above, a Holdco would be a good option for you. While a trust might provide more flexibility in the future, the admin costs wouldn't be justified at this time.

So how do you introduce a Holdco into your business structure?

Currently, you and your spouse hold common shares in the operating company. In order to introduce a Holdco, you will need to re-organize the current share structure.

This can be achieved by engaging your accountant. He/she, in conjunction with you, can prepare a valuation for the operating company. You will then exchange your common shares for fixed rate, redeemable preferred shares, representing the full value of the company.

A Holdco can now be incorporated in which you and your spouse own 100% of the common shares (in separate classes). You, your spouse and the Holdco can then subscribe for common shares in the operating company. The share structure should allow for the Holdco to obtain 12% of the common shares.

What benefits have you received from this re-organization?

Creditor Proofing

As the Holdco owns in excess of 10% of the voting shares in your operating company, profits can now be pushed to the Holdco via tax free inter-co dividends.

Moving excess cash out of the operating company reduces the potential claim that a creditor can bring against you in future.

Qualified Small Business Shares

A Holdco will allow you to "purify" the operating company, enabling you to claim the Lifetime Capital Gains Exemption (LCGE), in the event you decide to sell your shares in the future.

Claiming the LCGE would potentially eliminate capital gains tax on the sale of shares (up to the amount of your available exemption). This would not be the case if the Holdco was not introduced as the excess cash would result in the operating company failing to be a Qualified Small Business.

Investment Company

Accumulating funds within your Holdco to be used for investment purposes may be more beneficial than withdrawing the same funds personally and then using for investment reasons.

Each situation, and each investment should be reviewed with your tax advisor to determine the most beneficial plan for you.

Dividend Planning

Depending on the structure of the operating company, a dividend paid to one shareholder may have to be paid to all shareholders. This can result in personal income that not all shareholders require.

The use of a Holdco allows payment of dividends without the usual personal tax implications. This will allow you and your spouse to plan accordingly and defer tax on personal income until retirement, typically when you are in a lower tax bracket.

Conclusion

You've worked too hard and too long to leave your retirement to chance. Leaving yourself open to potential creditor claims is not a smart business practice.

If a Holdco is right for your business, it is a simple step to take to protect yourself and your family.

If a Holdco isn't right for your business at this time, consider implementing one of the other steps noted above. You'll be happy you did.

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