ASSET PROTECTION 101 FOR OWNER MANAGERS: THE ONLY THING HARDER THAN MAKING MONEY IS HANGING ON TO IT

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Let's face it – a main motivation to own and run your own business is to make more money than you would make working for someone else. However, the only thing harder than making money is hanging on to it. This is just as true for owner managers as it is for anyone else. This article describes some strategies to protect profits after you make them.

Setting The Stage

The success of an owner-managed business is measured by its ability to provide financially for the owner and his or her family. While profits often have to or should be re-invested in the business, in the long run you want to be able to take those profits out of the business and do other things with them. After all, owning your own business is a high-risk activity – something that will never change no matter how big or successful your business becomes.

There are some basic things successful owner managers can do to preserve and protect their profits. However, knowing which strategies to use, and when and how they should be used, requires competent and experienced professional advisors. A good business accountant and good business lawyer are essential for any successful owner manager, especially one with a profitable business who wants to make sure that those profits are used efficiently.

Owner managers also need a good tax advisor, a good banker, a good personal financial planner, and a good insurance broker.

Just as it takes a team to make big money, so does it take a good team to protect that money afterwards.

Protecting What You Have From Creditors

You should constantly be protecting your profits from creditors. There's nothing wrong with taking steps to minimize your exposure to your creditors, as long as you are not in any financial difficulty. The problems start if you wait until after hard times are upon you or you have experienced some setbacks.

Here are some of the basic asset protection strategies for owner manager. However, keep in mind that there are issues to be considered in each case. Some are unique to you; some depend on the laws in your jurisdiction. Using these strategies effectively requires good professional advisors.

Separate assets and liabilities – use your spouse. If you are married, and one spouse is in a high risk profession or is active in business and the other is not, it should be automatic to accumulate assets in the name of the spouse who is not at risk, which accumulating liabilities with the spouse who is at risk. Put your house and investments in the name of the low-risk spouse. Keep the low-risk spouse off the company board of directors and do not make them a company officer. These are standard strategies. However, make sure that this strategy will not hurt you in the event of a marital breakdown. You also need to balance this off with appropriate and effective estate planning.

Separate assets and liabilities – use a family trust. Depending on your situation, you can also separate your assets from your liabilities by putting some of your assets into family trust. This is a very flexible technique, which can include you, your spouse and your children as beneficiaries, and keeps you in charge of the trust as long as you are alive, competent and solvent. However, the assets in the trust will belong to the trust, which means your creditors and the creditors of your business cannot get at them as long as you set up and maintain the trust properly.

Do not keep surplus cash in your operating company. Get surplus funds out of your company. By using a holding company, those surplus funds can usually be paid out without incurring additional taxes. You can always loan the money back in if you need it, but don't let it build up in your operating company. There are good tax reasons and good asset protection reasons for doing this. However, check any financing you have in your company when assessing this strategy. Many lenders restrict your ability to pay profits out of the company without their approval. You would not to implement this strategy and then find you have defaulted in an essential term in your loan commitments.

Secure your shareholder loans. When you put money into your company, put it in as a secured loan, not as equity or unsecured debt. Take back a security agreement on your company's assets, and register that security on title in accordance with your local laws. It is perfectly legal to do so, it will rank your investment ahead of the company's unsecured creditors if the business gets into difficulty, it can be used to sell the business to yourself if a financial restructuring becomes necessary, and it will not negatively impact your bank financing. As long as you enter into a written priorities agreement with your bank, your secured loans will not be an impediment to bank financing as the bank will rank ahead of you. The bank should even treat your investment as "equity" for the purposes of tangible net worth and other margin calculations. If at all possible, this security should be put in place before or at the same time that you first put money into the company. A further benefit – in most cases these funds can eventually be repaid back to you without incurring any personal income taxes, as they are simply repayments of loans made with after-tax dollars.

Avoid personal guarantees. Personal guarantees open the door to all your assets. Avoid them as much as possible. If you have to give them, put your personal assets into your spouse's name or into a family trust, so the guarantee does not put your personal assets at risk. If it is impossible to avoid having to give a personal guarantee, consult your lawyer. You may be able to reduce your exposure under the guarantee by limiting the guarantee to a fixed dollar amount, or for a limited amount of time, or both.

Protecting What You Have From The Tax Man (Or Woman)

Profits attract taxes. The more profit you make, the bigger the tax bill.

However, it is perfectly legal to organize your affairs to minimize your taxes, as long as you do it with proper advice based on your unique situation and your local legal and tax requirements.

Start by getting professional tax advisors and consulting them regularly – at least once a year. It is absolutely critical to get professional tax planning advice from a competent and expert tax advisor, usually a qualified accountant but occasionally a tax lawyer. They should get to know you, your family and your business situation. You should meet with them at least once a year; not only to help with your annual tax filings, but to assist you assess and implement any tax-saving or tax-deferral strategies that could be appropriate for you.

Appreciate the difference between tax savings and tax deferrals. Some tax strategies actually save taxes; others simply defer the payment of taxes to a later date. Unfortunately, most tax strategies are of the deferral type, not the savings type. That does not mean they are not worth pursuing. Tax deferrals often have the benefit of allowing you to earn income of the amount of the tax deferral, which can really add up over time. However, it is important to truly understand your tax strategies, including what it does for you and your cash flow now and what it will do for you in the future.

Use holding companies. Using holding companies can be a good tax deferral strategy. Dividends to holding companies usually do not attract tax at the time they are paid out as they are inter-company, after tax payments. Dividends paid to you personally will usually attract taxes when they are paid out, as the "profits" are leaving the corporate structure. Therefore, dividends to a holding company can be a valuable way of getting profits out of your operating company on a tax-deferred basis where they can be used for investment purposes. This is only a tax deferral, however, as you will eventually have to realize on the profits made in the holding company in a manner that triggers tax. The death of a shareholder, for example, is a "deemed disposition" in manner jurisdictions resulting in a notional sale of shares and triggering potential capital gains tax.

Involve family members as shareholders. Involving family members as shareholders may allow for some income splitting possibilities, as well as special capital gains treatment in some jurisdictions in the event the business is sold. They can hold non-voting shares to keep them from having any say in how the business is run. The shares can be held through a family trust, allowing a great deal of discretion in which family member gets what money and when.

Use family members, especially your children and grandchildren, in your succession and estate planning. Using techniques known as "freezes", you can "freeze" the present value of your business on a tax-deferred basis, and transfer future growth in your company to younger family members who will out-live you or perhaps even succeed you in the business. This technique is particularly valuable if it is implemented prior to a growth spurt in your business, and can be a way of grabbing enhanced capital gains exemptions on the eventual sale of your business in some jurisdictions. This can reduce taxes paid by the family unit in the long run, or defer taxes until long after your death or retirement.

Maximize RSP contributions. The RSP is still an excellent tax reduction and tax deferral strategy if properly used. If you can, maximize RSP contributions every year for you and your spouse. Your tax advisory and accountant can help make sure that this makes sense for you and your family and that you are doing it in the most effective manner. For example, direct contributions made by your company to your RSP can be managed to avoid the company collecting and remitting source deductions that would have to be collected and remitted if your company paid you enough money to make the contribution from personal funds.

Consider other tax pension and insurance-based tax management strategies available under the Income Tax Act. There are other strategies you can employ if you have maxed out RSP contributions, such as individual pension plans (IPPs), retirement compensation arrangements (RCAs) and employee profit sharing plans (EPSPs). There are also insurance-based programs that will give your company tax deductibility today and allow you to avoid paying taxes until you utilize the funds in question. Knowledgeable tax advisors can advise you whether any of these programs might be appropriate for your situation.

Have a well-thought-out succession and estate plan. Selling your business or your death could automatically trigger capital gains recognition. It is important to have structured your affairs to minimize and defer taxes as much as possible by working with your accountant and lawyer. Techniques like dual wills (one will for your shares of private companies and one will for your other assets), living and testamentary trusts and use of life insurance products can shelter your family from tax burdens or defer taxes in the event of your death. Get good professional advisors and use them wisely.

Protecting What You Have From Yourself

Finally, you need to protect those hard-earned profits from yourself. There is nothing worse for your long-term financial prospects than to take business profits and invest them in personal lifestyle, personal assets or an unwise business expansion at the wrong time.

It can also be a terrible mistake to take personal assets safely outside the risk associated with your business and put them back into your business when it is struggling or failing. Sometimes you can be better off in the long run by letting a business fail then to risk your long-term financial prospects by propping up losing cause.

There are some basic things you can do to keep yourself from making these kinds of mistakes:

Have good professional advisors and use them. There is no substitute for regularly consulting a good business accountant and a good business lawyer who know you and your business. Between them, they will have a wealth of experience to help you keep things in perspective. If you keep them current on your business and your personal finances, and if you consult with them before making major decisions, they can help keep you from doing something you will regret.

Maintain a board of advisors and use it. In addition to professional advisors, it is good to have a board of advisors. They can include your lawyer and accountant, and other business advisors and associates. If properly constituted and maintained, your board of advisors will hold you accountable, will ask you tough questions, and will encourage you to manage your business and personal finances based on solid business principles, not whim or instinct.

Have a good business plan and keep it current and use it. Poor planning is at the core of many business catastrophes. Owner managers tend to manage by instinct, but a proper business plan can be the difference between anticipating trouble beyond your control and bringing trouble on yourself. When business performance diverges from the plan, you can assess whether there is a problem with the business, a problem with the plan, or both. Sometimes corrective action is appropriate, sometimes it’s not. Many factors beyond your control can impact the success of your business such as changes in technology or the relocation of a larger competitor into your space. Sometimes these changes aren't worth fighting.

Keep your company properly capitalized, using third party money as appropriate. Businesses fail because they run out of cash at the same time as they lose the ability to raise cash by debt or equity. In other words, they run out of capital. Most owner managers are not strong Chief Financial Officers, and either lack the financial resources to hire one or don't value what a strong CFO could do for them. As a result, most owner-managed companies are either under-capitalized or over-capitalized. Both scenarios represent lost opportunity and risk for the owner manager. If you agree that investing in your company is and always will be "high risk" compared to other investment opportunities, then using too much of your own money to finance your business is increasing your risk. It may also result in a company that is long on retained earnings or equity but short on real cash resources to deal with unexpected threats or opportunities. There is nothing wrong with levering your company assets using lower cost (?), third party debt and financing in the right situation. This frees up your money to put into lower-risk investments. It also confirms that you are on the right track. If you cannot attract reasonable banking and investment support for your business, there may be something wrong with it. If money is readily available at reasonable cost, it is confirmation that your business is healthy and on the right track. Therefore, getting prudent capitalization advice and implementing it can ensure that your business maximizes your family's financial potential without unduly risking everything you have built.

Think long and hard before putting personal money back into the company after you have gotten it out. You should never let your love for your business cloud your judgment. Taking profits out of the business and getting them safely invested in other assets – houses, real estate, investment accounts – is a major accomplishment. Many clients have lost everything by throwing money back into their business. Make sure you have used as many of the strategies noted above as possible, especially those involving good advisors and good business planning, before you do so.

Concluding Thoughts

This is a topic every owner manager needs to consider on a regularly basis, especially as their business profits become established, reliable and predictable.

It becomes even more important if you are contemplating selling or exiting your business.

Most owner managers do not do much more than make a modestly good living from their business.

A lucky few get the chance to do that for a prolonged period of time.

Some even get to accomplish a lot more than making a good living.

However, no owner manager should assume or count on being able to make good money indefinitely, on being able to extract maximum value from their business when the time comes to move on, or being able to make an owner managed business pay off more than once in a lifetime.