What will happen to your business when you pass away?

By Bruce Cohen

If you own a business, what have you done about planning for what will happen when you die?

"The most vital element in estate planning is the area of business succession planning," according to Wolfe Goodman, a prominent Toronto lawyer who has been doing estate planning for 45 years. Goodman is a senior partner in Goodman and Carr.

He recently warned Toronto members of the Canadian Association of Financial Planners that without succession planning a client's estate plan "is likely to go down the drain" because the business would probably be sold at a firesale price.

For example, Goodman cited medical practices, which still tend to be run solo though group clinics are growing. He feels doctors, dentists and similar professionals should strike deals to buy each other's practice "on a sensible financial basis" should the need arise. "In most cases, there is a real value to the deceased's solo medical practice but it is rarely realized by his family unless arrangements have been made in advance," Goodman warned.

(Goodman's comments brought to mind my own former family doctor. When poor health forced her to stop work, patients were just sent names of a few other physicians. There did not appear to be any attempt to sell the practice.)

Goodman said it's often felt that employees are logical successors for other types of

The coverage should be based on the insured's ownership interest, not an arbitrary 50-50 split, Goodman said. For example, say a business is worth $1 million with Sam owning 60% and Al 40%. Al would insure Sam's life for at least $600,000 while Sam insures Al for at least $400,000.

Frequently, Goodman said, people like Al complain it's unfair for them to pay more for insurance than their partners, and seek a bonus to cover the difference. That's especially true if the partner's premiums are also higher because he or she is older. But Goodman said it's only fair that Al pay more since Sam has a greater interest in the business and his older age makes it more likely he'll die first.

Goodman also rejected the notion of having the corporation buy the insurance instead of the individual partners. "The advocates of such corporate-owned life insurance rarely point out that this arrangement seriously distorts the allocation of the burden of annual premium payments", Goodman said, again citing Sam and Al's 60-40 ownership split.

Say the two policies cost $13,000 a year - $9,000 for Al's coverage on Sam's life and $4,000 for Sam's coverage on Al. If the business foots the bill, Sam's 60% ownership means he indirectly pays $7,800. "He is unlikely to think that this is a fair arrangement, as indeed it is not," commented Goodman.

one-owner businesses. But he finds that rarely works. The problem is financing.

One financing idea is for key employees to insure the owner's life. But Goodman said it's "very unusual" for employees to be willing to pay premiums over many years to fund a business purchase they eventually may not want.

Often, he added, the key employees expect the boss to pay them annual bonuses high enough to cover the insurance bill. "This rarely makes any sense at all, "Goodman said, noting it means the owner ends up funding the buyout. He suggests the owner just use the money to buy his or her own insurance. The proceeds would go to the family and the owner's will would direct the executors to simply sell the business at the best price possible.

Partnerships are much easier to deal with since a logical successor is already in place. But again, financing is the big hurdle since the surviving partner ideally should be able to completely buy out the deceased's survivors.

"Life-insured survivorship or buy-sell arrangements are far and away the best solution," Goodman said. "Frequently they are the only possible solution."

Keep it simple, he advised the planners, dismissing most complex strategies in favor of traditional "cross-insurance" where each partner insures the other.

Corporate-owned insurance would also expose the policies' proceeds to claims by business creditors, he warned. And he predicted disputes with the deceased's estate over the value of the business once the policy's payout is added to the corporate cash.

Goodman said the main argument for corporate-owned insurance is that premiums can be paid with cheaper money since corporations pay less tax than their owners - especially if the firm qualifies for the small business deduction. But he said the same benefit can be realized with traditional cross-insurance.

Goodman outlined a strategy in which Sam and Al each set up a holding company to own their shares in the operating business. Each year, out of its after-tax income, the operating business pays dividends that the holding companies receive tax-free. That money is then used to pay the premiums.

Say the dividends total $22,500. Reflecting its 40% ownership stake, Al's holding company would receive $9,000 - just enough to pay for the coverage on Sam. Sam's holding company gets $13,500, using $4,000 for the policy on Al and investing the rest.