STRUCTURING YOUR CONTRACTING BUSINESS

Part One: Introduction to Common Structure Issues

Many factors can influence the success of your business—not least of which is the legal structure of the business itself. Using the wrong structure for your situation can have far-reaching tax consequences. So as your enterprise grows and becomes more successful, it becomes increasingly important to update your business structure.

I have seen many situations where the corporate structure for a business or a group of companies has become extremely messy and puts the business owner at a distinct disadvantage. This is especially common for businesses that are in the growth or maturity phase. Very often the business has come through a period of rapid change and growth and has started to generate excess funds, accumulate significant business assets or acquire additional business lines.

While these are all good things on the surface, they can start to cause problems if the business is not structured correctly.

Fortunately, it is possible to reorganize your corporation to fix some of the common problems and take maximum advantage of tax planning opportunities. However, there is no one-size-fits-all solution; you must consider the specifics of your situation before determining the optimal business structure. Over the next three parts of this series, we will look at a case scenario example from several different perspectives.

Case Scenario Example: Introducing Jim

Jim is the sole shareholder of HoldCo, and HoldCo is the sole shareholder of JimCo. In addition to the shares of JimCo, HoldCo holds shares of RealCo that holds rental properties.

Through Jim's hard work, JimCo has been extremely successful over the past number of years. JimCo now holds significant equipment and has paid off most of the equipment financing. JimCo also holds an investment portfolio of $1,000,000 and shares of a trucking business (TruckCo). It is expected that JimCo and TruckCo will continue to accumulate excess cash of $500,000 a year for the next few years.

Jim is married to Sarah and they have two children who are in university. Sarah does administrative work for JimCo one day a week and is paid a small salary from JimCo. Sarah has no other source of income. Jim and Sarah's children have no sources of income and at this point neither has expressed an interest to become involved in the JimCo or TruckCo businesses. Jim currently has no plans to retire or to sell, but realizes that at some point he will need to step away from the businesses.

Common Problems Caused by Inappropriate Structures

Are there concerns with Jim's group of companies? Absolutely. It appears that as Jim's businesses have grown, various updates were made to his business structure that make little sense when you look at the big picture.

Jim's current structure leaves him open to a lot of different kinds of risk. With his current structure, Jim has many possible tax issues, succession and exit plan issues and other miscellaneous risks associated with creditors and estate planning. In the next three issues, we will delve deeper into these different angles and discuss the issues with the structure relating to each of them.

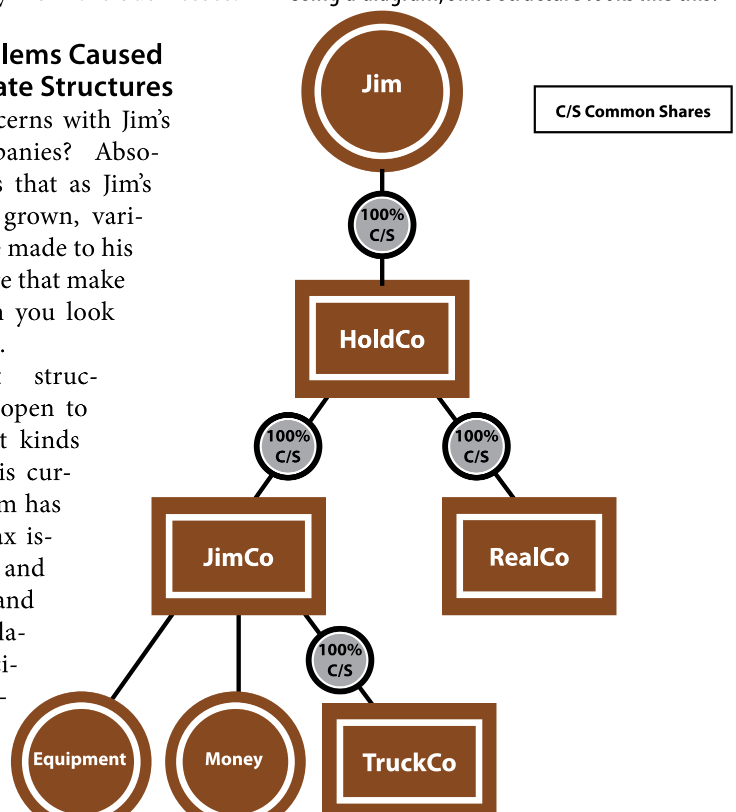
Tax Issues

Jim has no means of utilizing his Capital Gains Exemption (CGE) should someone offer to buy either of his operating companies (JimCo or TruckCo). This is a large tax exemption that could allow him to sell and have more money to retire with, should he structure things differently.

Both JimCo and TruckCo are generating excess cash, yet there is no method of removing the funds from the corporate group without subjecting them to personal tax. Without other means to remove funds, Jim is subject to the highest personal tax rates for income over $202,801 annually.

Under the current structure, there is no means of splitting income with Jim's family members other than through the payment of a salary. By income splitting with his wife, they could lower the family's overall tax burden annually.

Using a diagram, Jim's structure looks like this:



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United States. In that case the promises made in the Jay Treaty could be used to plead a case for allowing First Nations in Canada to obtain "exemptions" from restrictions and duties. Considering the hard-nosed attitude of the US Lumber Coalition that may seem like a hard sell, but Gary Bull, head of Forest Resources Management at UBC, says there's reason for optimism. A few years ago Professor Bull invited the US Lumber Coalition and various other players to engage in a dialogue at the university, and while not much changed on an official level, US coalition members did say that "if there is anything we are sympathetic to, it is community forests and First Nations." One could infer from this that the Americans would at least be open to discussion.

In any event, Professor Bull says that the proposition is worth testing if only because of the way in which it could potentially advance tenure reform in BC, a system he describes as completely dysfunctional.

"If we're going to have a solution for a lot of the forest land base in Canada we're going to have to involve Aboriginal communities in finding a joint solution," says Bull. "If that becomes the vehicle for moving material across the border, and it gives Aboriginals a fair share of the business partnership, then it's a sensible thing to do."

Potential industry partners for First Nations looking to advance cross-border trading are also paying attention. "It's definitely an interesting prospect," says John Iacoviello, forestry and timber development manager at Probyn Log. "Hopefully we'll hear more about it."

Dusty old document that it may be, the Jay Treaty nevertheless illustrates recognition on the part of the treaty signatories that First Nations had, and should continue to have, the right and ability to travel and trade in their traditional territories, and that that right should not be infringed.

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Succession and Exit Plan

Given that JimCo holds the shares of TruckCo, there are complications that will arise should Jim want Holdco to sell the shares of JimCo. If Jim's children decide that they would like to be involved in any of Jim's businesses, there is currently no means of allowing them to share in the future growth of JimCo.

By restructuring Jim could be able to uncomplicate the sale of JimCo while keeping TruckCo or he could bring in means to allow the children to share in future growth as they learn to run the business.

Creditor Risk

Given the nature of Jim's businesses, there is significant exposure to creditors. Should an accident occur in JimCo, creditors can make a claim against any of the assets of JimCo.

Estate Planning

Currently no estate planning work has been done to attempt to minimize Jim and Sarah's estate tax should they both die. All the value in the corporate group currently attributes to Jim and as the value of the group grows, the estate tax liability to Jim and Sarah grows.

In Conclusion

As you can see from the above case scenario, inappropriately structuring the business can result in significant tax and business issues. It's important to discuss your individual circumstances with a professional who can guide you and help you effectively plan for a business structure. However, over the next few issues I'll show you how Jim can update his business structure to address his tax issues, plan to exit, protect his assets, and plan his estate effectively.

Stay tuned for Part Two: Tax-based structures where we will talk about ways Jim can update his structure to be more tax friendly.

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