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Insurance solutions for small business owners

Small businesses fail for a number of reasons, including lack of planning, poor management, inadequate funds, downturns in the economy, debt overload, etc. As you work with your small business clients, you will want to help them find financial solutions that bring stability to situations where they can be particularly vulnerable.

You can help small business owners plan for the unexpected

Life insurance can provide a cost-effective solution for many situations that could threaten a small business, such as the loss of an owner or a key employee. This section provides an overview of how life insurance can be used to help a small business plan for the unexpected, including:

- Key Person Insurance
- Business Loan Protection
- Buy-sell Funding
- Funding Capital Gains Tax on a Business at Death
- Split Dollar Arrangements

We also look at how life insurance can provide small businesses with an opportunity for tax-advantaged investing and how it can be used as part of an enticing compensation package to attract the best employees.

Key Person Insurance

Business owners and other key executives spend considerable time and effort to acquire the knowledge, experience, judgment, reputation, relationships and skills that make them valuable to the business. When they die, the business loses a key member of the management team and this can have a severe financial impact.

During the disruption that follows the death of a key player, lenders may cut back credit, creditors may press for immediate payment, debtors may delay making payments, employees and customers may lose confidence, and competitors may take advantage of the situation.

Large corporations are often in a much better position to prepare for key executive turnover because of sheer size and numbers. Unfortunately, in small business situations, finding an immediate replacement with the same qualifications as a deceased owner or executive is much more difficult.

It is often necessary to look outside of the business to find a replacement, causing delays, disruption and reduced efficiency. The resulting effect on business profits may further weaken the financial stability of the business. In the absence of proper planning, the very survival of the business may be affected by the death of a business owner or a key executive.

The impact of this situation can be considerably reduced if the business has purchased an insurance policy on the life of the business owner and/or key executives. If they die, the life insurance proceeds give the business working capital to meet immediate cash needs and provide a source of funds for finding, attracting, hiring, and training a replacement for the deceased executive or to hire interim management.

Key person insurance provides assurance to a small business's creditors and employees that the business will continue even if a key person dies. The life insurance proceeds provide immediate cash to cover the business's working capital needs and to find and train a suitable replacement for the person who died.

The value of these benefits to the business should far exceed the cost of the life insurance.

Business Loan Protection

It can be difficult to obtain adequate debt financing for a small business. Creditors will often require the business owner to personally guarantee a loan. The death of the business owner or another key executive may cause creditors to demand immediate repayment of outstanding business debts.

This can place a significant burden on the business and force the liquidation of key business assets at fire sale prices at a time when business results may already be severely impacted by the death.

In addition, if the business owner has personally guaranteed the debts incurred by the business, the owner or the owner's estate may be liable for any outstanding debts that the business is unable to pay.

If effective planning hasn't taken place, the business may not survive the owner's or another key executive's death.

A solution is for the business to purchase an insurance policy on the life of the business owner(s) or other key executives. Proceeds from the life insurance policy are tax free and may be used to pay down the outstanding business debts.

A creditor may require a small business to purchase collateral life insurance to protect the creditor's interests, particularly if the death of the business's owner could affect the value of business assets used to secure thedebt. In other cases, the business owner may simply want to ensure that business debts will be fully repaid if he or she dies to minimize financial risks for heirs and to permit the business to continue free of debt.

Generally, life insurance premiums paid for business loan protection are not deductible for tax purposes. However, if a life insurance policy has been collaterally assigned to a restricted financial institution, a portion of the premiums may be deductible.

A life insurance policy purchased for business loan protection can help a business negotiate loans and repay business debts with tax-free life insurance proceeds when a business owner or another key executive dies. It can also prevent business owners or their estate from becoming personally liable for the business debts if the owner dies.

Buy-sell Funding

A key component of an integrated financial plan is planning for business succession. The business interest often accounts for a substantial portion of the wealth the business owner has accumulated.

Ensuring that a plan is in place for the eventual transfer of the business interest will help the owner realize full value for the business interest and it will also help the business and the remaining owners survive the transition. This is particularly true if one of the owners dies prematurely.

Changes in ownership may create financial obligations for the remaining owners. Ownership changes can also have income tax implications for the withdrawing owner and the owners who remain.

An integral part of any succession plan is to ensure that financing is in place to fund the purchase and sale of the business interest if an owner dies. The succession plan should also provide the business owner with sufficient liquidity to fund the related income taxes and, where possible, take advantage of any tax deferral or tax minimization strategies that may be available.

For closely held corporations or partnerships, one of the most important tools for implementing a business succession plan is the shareholders' agreement or partnership agreement. Once the business succession plan is developed, an agreement can be drafted to reflect the needs and wishes of the various parties.

Life insurance is generally an efficient way to fund the obligation that results from a buy/sell agreement when a shareholder or partner dies. There are numerous possible ways to structure a buyout on death and life insurance funding plays an important role in ensuring the buyout occurs.

In considering the various methods for structuring a buy/sell agreement, you need to keep in mind that there is no "right way" to proceed. Each method has its own pros and cons and must be considered in light of the circumstances of a given situation.

Funding Capital Gains Tax on a Business at Death

Life insurance can also be an effective way to fund the tax liability that arises at death.

An individual who owns shares in a corporation, a partnership interest, or business assets (as in the case of a sole proprietorship) will be deemed to have disposed of these properties at death. As a result, a tax liability may arise in the form of capital gains and recaptured capital cost allowance. If funds or other assets are not available to pay the tax liability, the shares or partnership interest may have to be sold, or business assets may have to be liquidated, possibly for a price below the fair market value.

Life insurance can provide the funds needed to pay the tax liability that results from the capital gains and recaptured depreciation triggered by an individual's death. Life insurance is a particularly valuable funding vehicle if the beneficiaries want to retain the property or if the market conditions will not provide the estate with an amount equal to the fair market value of the property. The individual could own the life insurance policy, or it could be owned by the corporation or partnership and dispersed to the individual's estate after death.

An important consideration is whether to fund the buy/ sell arrangement with 'corporate owned' or 'personally owned' life insurance. Ensuring that the ownership is properly arranged from the onset will avoid a transfer of ownership in the future, which would result in a disposition of the policy and could possibly trigger a tax liability.

Split Dollar Life Insurance

Life insurance's versatility makes it an excellent choice for meeting a dual need experienced by many small businesses. It's common for one party within a business to need the financial protection that life insurance provides against death, either theirs or someone else's within the company, while another person needs a taxsheltered investment vehicle.

One life insurance policy can provide for the needs of both parties by using an arrangement commonly referred to as "split dollar life insurance". In these arrangements, one party typically funds and is entitled to the level death benefit portion of the policy and the other party is entitled to and funds the remaining interests in the policy (generally the cash value).

In the business context, a split dollar arrangement can be used in a number of different ways. For example, an employer may need key person insurance on an executive and the executive might want a tax-sheltered investment. The employer and the executive could enter into a split dollar arrangement where the employer funds and is entitled to a level death benefit on the life of the executive and the executive funds and is entitled to the cash surrender value component of the policy. The beneficiary of the level death benefit is the employer, while the beneficiary of the cash value is designated by the executive (his or her spouse, for example).

Executive Compensation

Small business owners often offer supplementary benefit packages to attract executives. These packages offer a wide assortment of benefits, which may include life insurance protection.

The life insurance protection ensures that if the executive dies, his or her dependants receive money that can be used to cover funeral expenses, education costs, reduce debt and provide future income.

The policy may be purchased by the business/employer, or it may be owned and funded jointly by the employer and the executive. The executive's dependants would be named as the beneficiary of all or a portion of the policy.

The employer paid portion of the life insurance premium must be reported as a taxable benefit to the executive. It is important that the amount reported represents a reasonable cost for the benefit received.

Death Benefit Need		Tax-Sheltered Investment Need
Buy-sell funding (corporation/ partnership)	→	Shareholder or partner investment vehicle
Business loan protection (corporation/ partnership)	→	Shareholder or partner investment vehicle
Business loan protection (operating company)	→	Wealth creation (holding company)
Employee life insurance protection (employee)	→	Wealth creation (corporation)
Key person protection (employer)	→	RCA funding (RCA trust)

Wealth Creation

Often a business's profits or surplus cash are invested in GICs or taxable investments. These taxable investments may not be the business's best investment option.

If the business already needs an exempt life insurance policy for key-person insurance, business loan protection or some other business insurance need, the policy could also be used as a vehicle for investing the company's excess profits.

An exempt, permanent life insurance policy allows for tax-deferred growth of the cash value and tax-free receipt of the proceeds at death. The cash value growth within an exempt policy is not subject to annual accrual taxation and is only subject to tax if there is a disposition of the policy.

Significant cash value can accumulate on a tax-deferred basis if the business deposits the maximum amount permitted by the Income Tax Act into the exempt policy. The deposits can remain within the policy on a taxsheltered basis and pay for the cost of insurance and expenses in future years.

If the corporation or shareholder needs access to the cash at some future date, the policy's cash surrender value can be accessed through withdrawals or a collateral loan secured against the insurance policy.

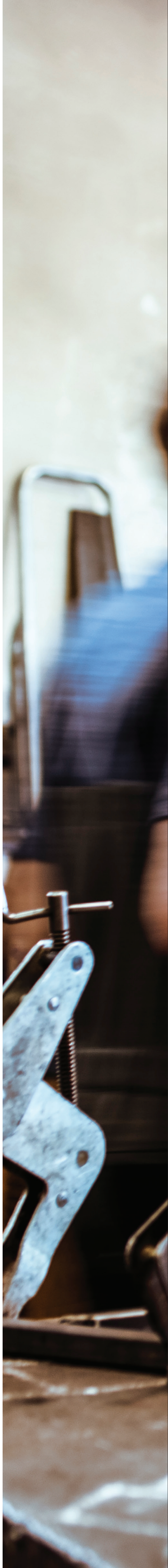
Policy withdrawals may trigger some income tax at the time of the withdrawal. Advances to the corporation received as a collateral loan will be tax free and if the proceeds are used to earn income from a business or

property, and the other requirements of 20(1)(c) of the Act are met, the interest expense may be deductible for tax purposes.

Conclusion

Life insurance can be used to protect the interests of a small business owner and to ensure the continued operation of the business itself. It can provide security for creditors during a period of change and assurance that the business will continue even if a key person departs. It can also be instrumental in attracting and retaining excellent employees, who will work to assure the continued success of the company.

As you work with small business owners to develop an integrated financial plan, you will want to consider life insurance as a cost-effective solution for their current situation and as a means of achieving the stability that is so essential to their future success.



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