Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Wealth planning for health-care professionals – Preparing for retirement

Tax, financial and retirement planning will always play a key part at every stage of your career, whether you're a new graduate, working as an associate, running your own practice or approaching retirement. As your personal, professional and financial situations continue to evolve, you should ensure that you've done appropriate planning to help you achieve your goals and objectives throughout the different stages of your professional life. This article discusses the relevant issues you face when you are in the pre-retirement phase of your career.

Retirement planning

You have spent considerable time building up your practice and have an established patient base. As you approach your retirement years, have you decided what to do with your existing practice? How do you plan to exit from your current business? Do you have a sufficient stream of income or assets to fund your retirement? All of these questions will need to be addressed as you are nearing retirement.

The first step to developing your retirement plan is to assess and identify your current financial situation and determine how much you will need during retirement. From a financial and professional perspective, you'll need to determine what your retirement goals are and how the transition or sale of your practice will occur. You should seek help from a qualified advisor to assist you in this process to ensure that you have considered all aspects of your financial situation.

The next step may be to develop plans to achieve your retirement goal. Depending on your circumstances, your practice transition strategy may differ. Due to the nature of the profession, the patient market and the relative ease in opening a practice, there may not be a market for a physician selling a practice. On the other hand, there is generally a market for dentists selling their practices. The market in which you practice should be considered to determine the exit strategies that are available to you.

You will need advice from a variety of sources including an accountant, lawyer, and financial planner to help you coordinate both your plan for transition and the sale of your practice. These professionals can assist you in determining the after-tax amount you can expect to receive when exiting your business, while taking into account your retirement goals and funds available to create a plan that meets your needs.

Leaving your business

A business succession plan is a detailed roadmap that identifies your potential successors and provides direction on how the ownership of your business will be transferred to another party upon your retirement. There is generally no succession plan for physicians as the existing practice is typically wound-up on the physician's retirement. For dentists, the transition of the practice is usually done in one of two ways: 1) an internal process whereby the practice is transitioned to an associate already working in the practice; or 2) an external process whereby the practice is sold to an external party, usually another professional.

Winding up your practice

If your practice cannot be sold, consider winding up the operations of the practice and liquidating its assets. You don't have to wind up your professional corporation (PC) when you stop practicing. If the PC has built up retained earnings (profit left inside the corporation), you may be in a position to take out the retained earnings over your retirement years as dividend distributions from the corporation. Talk to a legal advisor about revoking the PC's licence or permit and converting the PC into a regular corporation (e.g. holding company) upon retirement. Also, depending on your province of residence and the type of corporate structure in place, consider a reorganization to consolidate or simplify your holdings to minimize costs and administration.

Internal sale

Internal sale involves transitioning the practice to an associate already working in the practice. In the case of a family practice, the successor may be a younger family member. This type of sale may be easier than dealing with an external purchaser for several reasons. The associate will have insight into the existing practice and is generally familiar with you. This may mean less conflict during the planning process and an increased likelihood that the planned succession will transition smoothly. Finally, as the associate is familiar to the patients, suppliers and staff members, an internal transition sale may minimize disruption and maximize continuity for all parties involved.

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Typically, once the associate has practiced with the selling dentist for a certain period of time (a period of two to five years, depending on experience) and has generated a certain amount of business (based on a percentage or actual amount of revenue dollars), the associate would begin to "buy-in" to the practice. The associate continues to buy more of the business as they gain more experience and eventually purchases the whole practice. At that point in time, you can choose to either retire or work as an employee or consultant of the practice. This method of transferring ownership interest of the practice allows for a gradual transition, providing flexibility and reducing some of the uncertainty inherent to the process.

Generally, in a business sale to an internal party, an "earn-out" provision is used whereby you, the vendor, receives a lower price on the initial sale of the business but includes a provision in the sale contract which indicates that future compensation is to be paid by the purchaser to you if certain financial results are met (i.e. the business meets certain revenue or profit targets). Other internal buyouts are structured to occur over a number of years. This allows for the funds to be gradually transferred to you while the new owner is able to gradually assume control and responsibility within the same time frame. This kind of "staged exit" may be particularly desirable when the business represents a large portion of your net worth. You may be able to spread the receipts and benefit by spreading the attached taxable capital gains over a maximum period of five years.

External sale

For dentists looking to maximize the value of their practice, a sale to an external party (i.e. an entity or a third-party individual) may be the best option. A typical scenario would be the sale of the practice to another professional, group of professionals, or other practice related organizations.

It is often recommended that a business valuator and business broker be hired as part of a team of professionals to manage the succession planning process and the eventual sale of a practice. The business valuator can help determine an appropriate value of the practice. A broker that specializes in healthcare can help

find the right buyer and navigate you through the sale process. Planning for this type of transition is normally more difficult because of market uncertainty at the time of the desired transition. Also, an interested buyer may require significant disclosure of patient demographic and financial information as well as have their team of advisors perform a certain amount of due diligence. This process may involve the buyer requesting access to sensitive information that you may not necessarily wish to provide. It's recommended that you have a qualified legal advisor involved in this process as early as possible to help determine what information can and should be provided to the potential buyer as part of the due diligence process, as well as to assist with negotiating and structuring the sale of the business. This type of sale generally involves a period of time in which the buyer and the seller work in the practice simultaneously to help facilitate a smoother transition.

Consider all parties involved

The sale of a practice usually involves the practice owner, the potential buyer, and their team of advisors. However, there are other parties affected as well, such as the patients, staff members and other parties to the business relationship such as creditors and suppliers. If you're planning on selling your practice, it's recommended that you consult a qualified legal advisor regarding the sale process as early as possible, who can advise you with respect to any of the following: any existing partnership or shareholder agreement between you and the other parties; negotiations with the landlord about leasing arrangements; and, the handling of patient lists, existing contracts and business agreements with creditors, suppliers, associates, and patients.

Asset sale vs. share sale

Whether the sale of the practice is structured as an asset sale or share sale will depend on the negotiations between the parties and terms of the contract. As the seller, the asset sale versus share sale decision will depend on a number of factors, including the ultimate after-tax cash amount to be received personally. On a share sale, the after-tax cash to you is equivalent to the net cash you retain after you pay tax on any capital gains. You should also consider whether you can claim the lifetime capital gains exemption (LCGE) to offset all or a portion of the gain on the sale of your shares.

In order to compare the after-tax amount receivable on a share sale versus asset sale, it's necessary to perform the calculations as if the PC will be wound-up on an asset sale (even if this is not your intention). This notional winding-up calculation represents a "worst case scenario" as it assumes that all personal tax is paid immediately, when

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in fact, a deferral of tax is likely if you only take capital dividends out of the corporation and draw on the retained earnings in the future (i.e. during your retirement years). The amount that you should be willing to accept under an asset sale should be comparable to the amount that you will net after-tax on the sale of shares.

Determining the amount the purchaser may be willing to pay for the shares is a bit more complex. Generally, purchasers prefer buying the assets rather than shares, whereas the seller would prefer selling the shares rather than the assets. If the purchaser buys the assets of the PC, then there is full cost base in the assets (equal to fair market value) to the purchaser. The purchaser will then be able to depreciate the assets from this value. When the purchaser buys the shares, they're essentially taking over all the assets and liabilities of the PC. The PC generally retains the lower historical tax values of the assets. Therefore, the purchaser will generally discount the share purchase price by the amount of tax savings in future depreciation that they're foregoing by purchasing the shares instead of assets. The seller on the other hand will generally prefer a share sale if the disposition of shares qualifies for the LCGE.

The outcomes of selling shares or assets are different for each situation due to the varying corporate and personal tax rates among the provinces, the dollar amount involved, and the availability and number of LCGEs which may be utilized where there are multiple shareholders.

Financial considerations

There are a number of financial factors to consider as you plan for your retirement. Tax and estate planning should be an on-going process throughout your working life to ensure that your plan continues to reflect your changing needs and meets your current circumstances. It's essential to ensure your plan is still on track to help you achieve your retirement goals. In addition to assessing your sources of retirement income, you'll need to review your succession plan periodically to ensure that the projected proceeds from the sale or transfer of your business, or residual cash flow from your corporation (if you end up winding up your practice) will last as long as your retirement does. It can

be difficult to replace an income stream in later years, so remember to factor in the effect of inflation and consider strategies that can increase the value of the funds you will receive from the practice transition well before your planned retirement date.

Consider your sources of retirement income and when will they be available

It's important to understand your sources of retirement income and how much recurring income will be produced by these sources and by existing income sources. Income sources could include the Canada Pension Plan (CPP) or Quebec Pension Plan (QPP), registered retirement savings plans (RRSP), proceeds from the sale of the practice, income from an ongoing interest in the practice, income from a new business venture, or an individual pension plan (IPP).

Consider how to manage these sources of retirement income to maximize their efficiency

Where will you obtain funds if you have a cash flow shortfall? The general rule is to withdraw funds from non-registered investments before redeeming funds held in tax-sheltered plans. This ensures you continue to defer paying tax on registered investments and preserves the power of tax-free compounding as long as possible. Consult with a qualified financial advisor about how to draw on your various sources of retirement income in the most efficient manner to minimize tax, maximize flexibility and make the most of the available tax credits.

Plan your retirement early

Will you need all the proceeds from the sale of the business to fund your retirement? Ensure your succession plan has taken this factor into account. How will you convert the funds received from the sale into an income stream available for you in retirement? If you are transferring the business to a family member, perhaps for little or no consideration, this should be taken into consideration in your planning. You will need to ensure that there will be sufficient income either from your business or from other sources to meet your lifestyle needs.

Estate planning

While you are in the process of positioning your business for an eventual sale and planning your exit strategy, you should also ensure your estate plan reflects your current wishes in the event something unexpected occurs. A comprehensive estate plan should contemplate not only the distribution of your assets on your death, but also which individuals or organizations would make decisions on your behalf, from both a personal and financial perspective if you become incapacitated. Update your power of attorney (POA), Will(s), and insurance coverage to ensure that if you or a key member of the practice becomes unexpectedly ill or dies, your personal and professional affairs can be taken care of without undue legal complexities or tax burdens.

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Consider the following:

- **Planned locum agreement** – A locum agreement is essentially a contract for services where the locum (temporary replacement physician or dentist) steps in to provide professional services to the practice's patients and maintain the practice's operations while the professional is away and cannot attend their practice. Having a locum agreement is good practice management as it reduces the uncertainty surrounding the situation where the professional is unable to perform his or her duties and allows the business to continue without interruption. It also allows the professional and the locum to negotiate mutually agreeable terms in advance.

- **Contingency plan** – In the event of a premature death, would you want your practice to continue, close or be transferred on your behalf? If you are the sole practitioner operating in your PC, the corporation does not cease to exist on your death. However, since only a registered practitioner can hold voting shares of the PC, and your estate is not considered to be a registered practitioner, your corporation would no longer comply with the regulatory requirement that only registered practitioners may hold voting shares of the PC. Therefore, your legal representative or ultimate beneficiary may choose to wind up the corporation, sell the shares or continue the corporation as a regular corporation that is not a professional corporation. If you're in partnership with other practitioners, you should consider putting in place a partnership agreement that includes an insured, tax-effective buy-out plan to be implemented in the event of the death of one of the practitioners.

- **Make or update your Will** – A Will represents the most fundamental element in any estate plan and is essential to ensuring your wishes are carried out with minimum expense and delay. Having an updated Will ensures that in the event of your passing, your property will be distributed to your beneficiaries according to your wishes and the individual or corporation that you wish to act on your behalf to carry out your wishes are able to do so.

- **Make or update your POA** – An enduring or continuing POA is a legal document which may become invaluable in the event you become incapacitated and cannot perform for yourself your normal daily tasks, such as paying bills and managing your investments. This document gives another person(s), referred to as the attorney(s), the power and authority to act on your behalf. A POA for property is used to allow the attorney(s) to make decisions about financial and property matters. A different legal document may be used in some provinces and territories to allow an attorney to make personal care decisions on behalf of another individual. In some provinces, you may be able to execute one document which will contain your authority for an attorney to act on your behalf in relation to financial and property matters as well as personal care matters.

- **Minimize double tax exposure** – Have you thought about what your beneficiaries will do if you leave them private company shares? You're generally deemed to have disposed of your capital property, including any private company shares, at fair market value on your death. Your estate pays tax on any capital gains realized on the deemed disposition of your shares on your death. If the surviving shareholders decide to wind up the PC, the corporation may be required to pay tax on the sale of the assets, followed by more taxes payable by individual shareholders when the proceeds are distributed to them. You can defer this double taxation by leaving shares to a surviving spouse. On death, the shares will roll over to the surviving spouse at cost. Another way to mitigate the tax impact on death is to have the shares sold by your estate if a buyer can be found. Other advanced tax strategies may be available so you should consult with a qualified tax or legal advisor to perform what is typically known as "post-mortem" planning. If you own private company shares, such as shares of your PC or holding company, give some thought to post-mortem planning when developing your estate plan.

Give your family and yourself peace of mind by booking an appointment with a qualified legal advisor who specializes in Will and estate planning to review and update your estate plan.

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