

Volume 14, Issue 5



October, 2000



## I N D E X

### TAXATION

*Guarantor's Recourse*

### MANAGEMENT

*The Six Pack of  
Success*

### MONEYSAVER

*Training Costs*

### TECHNOLOGY

*Application Service  
Providers*

## TAXATION

### Guarantor's Recourse

*If you are a guarantor of a business loan, you should be aware of your financial responsibility and recourse should the borrower default.*

The owner/manager that gives a personal guarantee on a business loan is assuring that the contract will be fulfilled. In the event that the company defaults on the loan, he or she will personally discharge the debt as required. But as lenders frequently also require additional personal guarantees, the owner/manager may ask family members to give their guarantees as well.

#### What if the borrower defaults?

If the borrower defaults, the guarantor must assume the debt obligation. As well as having to repay the loan, the guarantor may also face an unfavourable tax treatment for this loss that

could have been avoided with proper documentation and structuring. Guarantors typically do not consider the potential tax consequences of their personal guarantee until they face a situation where they must honour it.

For the guarantor, the key tax issues are:

- Can a deduction be claimed for the debt payment made under the guarantee?
- What is the timing of this deduction?
- Is the related interest expense deductible if the guarantor must borrow funds to make the payment?

Although the following discussion deals primarily with the tax implications where the guarantor is also a majority shareholder, these considerations may also be applicable to non-shareholder personal guarantee situations.

## The guarantor's rights

If the guarantor is required to honour the guarantee, the guarantor has a legal right of action to sue the principal debtor for the amount paid to the lender and is also entitled to an assignment of security given to the lender by the principal debtor. The guarantor therefore becomes a creditor of the debtor in his or her own right. It is in respect of these rights against the debtor that for income tax purposes, the guarantor may realize a loss in certain circumstances.

## Tax treatment of guarantor's loss

While the *Income Tax Act* does not contain specific provisions dealing with the tax consequences of providing and honouring guarantees, there may be some tax relief for the guarantor's loss.

The first consideration is that a capital loss does not arise by virtue of the guarantor making a payment. Instead, the guarantor must establish that the debt is a bad debt. This will require the guarantor to demonstrate that the original debtor is unable to reimburse the guarantor. As well, the deduction can only be claimed in the year that the debt is established to have become bad. In order for the loss to be claimed as a capital loss, the loan must have been made for an income-earning purpose.

To meet this test, it is generally sufficient for the owner/manager to demonstrate that the guarantee was made to earn dividend income on the shares that he or she owns in the company.

Unfortunately, when relatives guarantee loans, the arrangement to pay reasonable fees for this service (the only income-earning purpose they would have) is often overlooked. Where there is no consideration given, the capital loss and interest deductibility will not be allowed. In these cases, the CCRA considers the payment not to be of an income-earning nature, with no tax relief.

## Tax treatment of loan interest

Generally, to deduct interest on borrowed funds, the taxpayer must establish that the interest is paid pursuant to a legal obligation to pay interest and that the funds have been used for the direct purpose of earning or producing income. This "income purpose" test also applies to interest payments made on a loan incurred to honour a guarantee. If the guarantor takes over the position of the original creditor and can claim the

repayment of the debt from the debtor, the interest on the funds borrowed to honour the guarantee are deductible if a reasonable guarantee fee was received.

If no guarantee fee was received and the debtor is unable to pay reasonable interest to the guarantor, the interest is deductible only if the CCRA's administrative guidelines are met. These guidelines allow the deduction for interest if the loan, that was guaranteed, was to a Canadian corporation in which the individual was a shareholder, was used to earn income from a business or property, and the corporation could not borrow the money without the shareholder's guarantee.

## Talk to your chartered accountant

Before giving your personal guarantee or asking relatives or other shareholders to give their guarantees, talk to your chartered accountant to ensure you consider all of the implications of the transaction. Your chartered accountant can help you ensure:



- there is written agreement between the guarantor and the debtor that deals with the amount of the guarantee fee as well as the arrangements to be made in the event the debtor defaults and the guarantee is called and
- the lender provides written confirmation that the funds will not be advanced without the personal guarantee.

Once the financing is in place, review the company's debt situation on a periodic basis. If the debt/equity ratio improves, approach the lender to see if it is possible to have the personal guarantee removed.

# MANAGEMENT

## The Six Pack of Success

**L**ike many owner/managers, you likely do not have the security net of a regular paycheque. And certainly you are never going to get a settlement for dismissal or downsizing!

Here are six principles of success that can help entrepreneurs plan for the future.

### 1. Look after your personal liquidity

Have you put all of your future in your business or do you have personal working capital outside the business' bank account for riding out a downturn or worse? If your business is incorporated, consider raising your salary to accumulate personal savings. Set a goal to put away the equivalent of at least six months' earnings in personal savings or investments.

Of course, you should also consider stepping up your RRSP contributions to reduce the impact of income taxes on any additional draw or salary. At the same time, if you are not at the maximum, additional income will increase your RRSP contribution level. Until you need the funds, the RRSP will grow with tax deferred interest. If you need to withdraw funds before retirement, the timing and amount of withdrawals can be planned to reduce the tax burden. Alternatively, invest your personal savings in 30/60/90-day treasury bills or other short-term investments that will give you liquidity if you need it.

### 2. Look after your and your employees' future

Plan for both your and your employees' future. There are a number of methods of achieving this goal such as building up goodwill, setting up a profit-sharing or deferred profit-sharing plan, or creating a strong asset base as a source of income after retirement. You could also provide key employees with the opportunity to buy into the business on either an ongoing basis or at the time you retire. Regardless of the method, looking after your own future and the future of those that work with you will make

everyone's business efforts more rewarding and increase overall productivity.

### 3. Manage information

Maximize computer technology to control and provide the information you need. Make sure financial reports, exception reports and government and regulatory requirements are at your fingertips rather than piled high upon your desk. Set levels of authority and delegate responsibility for processing and approval of transactions. Establish deadlines for reports and transactions to be completed so that you can focus on reviewing data, finding solutions for problems and authorizing transactions above your employees' level of authority. Encourage staff to problem resolve rather than simply problem identify. (Anyone can present a problem. Encourage employees to give you suggested solutions so you have a choice of fixes.)

### 4. Plan for the unexpected

Ensure the survival of your business in the event of disruption. Not having a partnership or shareholder agreement and provisions for dealing with the impact of changes or disruptions could turn a profitable business into a trash heap overnight. Speak to your chartered accountant about the impact on your business if your business partner dies, if you divorce, or if you die. Your chartered accountant can give you guidance on the appropriate corporate structure as well as the need for shareholder/partnership agreements, buy-out alternatives, and various financing alternatives that can help ensure business continuity and sound estate planning.

### 5. Invest the company's excess cash

When times are good, work towards creating a reserve of working capital that will work for the business both now and in the future. Review your cash flow over the past few years and determine when excess funds usually accumulate. When your business has excess funds, consider investing in equity or interest bearing investments, even if it's only short term. If you can

can accumulate a base of excess funds, this can serve as security to negotiate a better interest rate for future borrowings.

## 6. Know when you need outside expertise

While you know a lot about your products or services, no one can be an expert in every aspect of the business. Assess both your strengths and weaknesses in areas such as computer technology,

human resources, business management, research and development and financial planning. Identify where the expertise of an outside contractor could benefit the company and then act on it.

Whether you are starting out in a new business or affirming your commitment to an existing one, these six principles can help pave the road to both personal and business success.

# MONEYSAVER

## Training Costs

**T***o maintain competitive advantage, a business must keep its systems up-to-date. Along with the costs of enhancements and new applications, the owner/manager must also deal with the related training for employees. How can you ensure the cost-effectiveness of your investment in training?*

While advances in technology give companies new opportunities and capabilities, the costs of training are sometimes not factored into the overall expense for improvements.

First, is training really necessary? If you are upgrading your printers, maybe not. After all, the end-users will simply send their output to a new printer. Of course, the person responsible for loading the paper and changing the toner will have to know how the machine differs from the previous models. However, if you're changing your software programs and applications, poorly trained or untrained end-users could negate the benefits of the new technology with costly errors and lower productivity. In these instances, proper training will save you money in the long run.

With careful planning, you can maximize your investment in training employees to use new technology effectively by following these three steps:

- involve employees from the outset;
- plan training programs carefully; and
- provide for a transition period before full implementation of the new program or hardware.

## Involve employees

Involving employees from the outset shows that the company values their input and helps reduce any fears they may have about the change.

- Communicate the goals that the company hopes to achieve with the addition of new programs or hardware.
- Involve end-users in the selection process. Not only does this involvement reinforce your respect for their input, it will also help you determine more quickly if the proposed hardware or programs will meet the company's goals.
- Explain how and when training will take place.
- Set a realistic target date for full implementation of the new process.

## Plan training programs

Whether you are developing your own training program, using a packaged one, or outsourcing the training process, the training should not only demonstrate how the new program works but also how it works within the context of the other processes within the company.

- Make the training as close to the actual work experience as possible. For example, if your staff will be learning how to use a new inventory management program, use the company's inventory data so that they are already familiar with the products.

- Plan to hold group training sessions in a conference room or an outside facility. Getting employees away from the phone and other distractions improves their concentration and enhances learning.
- Provide ongoing support to make training a continuous process. Once a new program is implemented, make sure employees have a contact - another staff person or an outside source - to turn to when problems arise.
- Encourage employees to upgrade their skills by offering incentives for the successful completion of outside courses.
- Whenever possible, schedule training programs during slow business cycles. It is easier for employees to learn new applications or programs when they have fewer concerns about their immediate responsibilities.
- Focus the training on the basic skills necessary to get the job done. Employees can learn the more advanced procedures on the job on a need-to-know basis as they gain confidence in the use of the new program or equipment.

### Provide for a transition period

A transition period is important for monitoring the new process or procedure and making any needed adjustments or refinements before making a full commitment to

commitment to the new program or equipment. Keep in mind that when implementing a new process, employees will make errors and productivity may falter during the initial learning stages.

- If new technology will change a business process that is critical to the company, run the old application or system in parallel for a transition period until the new system is proven.
- Participate in and perform testing to ensure that the new process or system works correctly and that it meets all of your company's requirements.

Once the new process is fully in place:

- Give employees an opportunity to assess the new process in terms of the goals such as enhanced productivity or improved communications. Their feedback and suggestions at this stage could help the company refine and improve the process further.



*To fully harness the benefits of new technologies, a business cannot afford to overlook the proper training of employees and management. A well-designed training program is an investment that makes bottom line sense.*

## TECHNOLOGY

### Application Service Providers

**K**eeping current with the latest versions of your software programs as well as assessing new products and services are time-consuming and costly business concerns. Maybe it's time to consider outsourcing your information technology (IT) resources.

Welcome to the New World of Web-based application service providers (ASPs), an emerging subscription software service that could prove as revolutionary as the PC in the '80s. By broad definition, an ASP is an outside company that hosts software applications on its server

that subscribers can access on a recurring fee basis, usually a flat monthly fee. The ASP delivers all the services the subscriber needs in the areas of application or network management and technical support. Some ASPs are accessible through a standard browser while others will require specialized client software. The subscriber accesses and uses the applications through their ISP (Internet Service Provider) as well as keeps its data files at the remote site.

What services are provided through ASP? Basically all and any services can be accessed through an ASP from

the standard business applications such as e-mail through to more specialized applications, such as:

- e-commerce;
- customer relationship management;
- resource planning systems;
- benefits administration and payroll services; and
- customized processes and applications.

### What are the benefits?

An ASP can save a company the tremendous amount of time and investment that is usually required for the set-up and maintenance of a traditional PC network. By outsourcing application hosting and support services, a company gains a virtual IT staff and infrastructure. Rather than incur the large and ongoing costs of purchasing and maintaining software, the company essentially rents it. Furthermore, it does not have to be concerned with upgrades, patches and ongoing maintenance. As the ASP also provides comprehensive security, back-up, disaster recovery and support services, the user can gain big business IT capabilities at an affordable price.

An ASP provides a company with several other benefits:

- The ASP's monthly fee lets you control the otherwise variable IT costs. The fee is typically based on the number of users and the scope of applications used.
- Your employees connect to network applications and shared databases at LAN speed (but not from their home modems).
- Employees can share files and collaborate online so there's no need for shuffling disks or sending e-mail attachments.

- As the ASP can be accessed from any location, employees on the road can access the company network.
- As users only need a PC with little memory and less processing speed or power (called a "thin client"), you can significantly reduce your hardware costs.
- When your company's needs grow, the ASP can help your company put the right software solution in place quickly and without interruption to the business.

### So what's the downside?

While there are many benefits to using an ASP, you have to carefully consider the other side of the coin. If your business uses an ASP for all of its IT needs, it will not develop any inside technical expertise and support. As your company data will reside on the ASP's server, security is a very important concern in choosing a supplier. While the monthly fee is relatively low, it is an ongoing outlay.

### Choosing an ASP

If you are thinking about using the services of an ASP, you first need to consider whether you want to augment your current programs with new applications or replace your existing system. As you would with any supplier, ask questions about the ASP's background and length of time it has been operating. You will also need to know the details of its service agreement and pricing structures, the type of software it offers, the hardware it uses and most important, its security and firewall systems. Since many providers now call themselves an ASP, you should determine if the company is a full-service ASP or works with partners to deliver the full package of services.

Some of the other questions you should ask include:

- Where and how are the application programs and data stored?
- How does the ASP administer software patches?
- What virus detection systems does it have in place? What systems are in place for back-up and recovery of data?
- Does it have redundant servers and communications networks to ensure uninterrupted service?



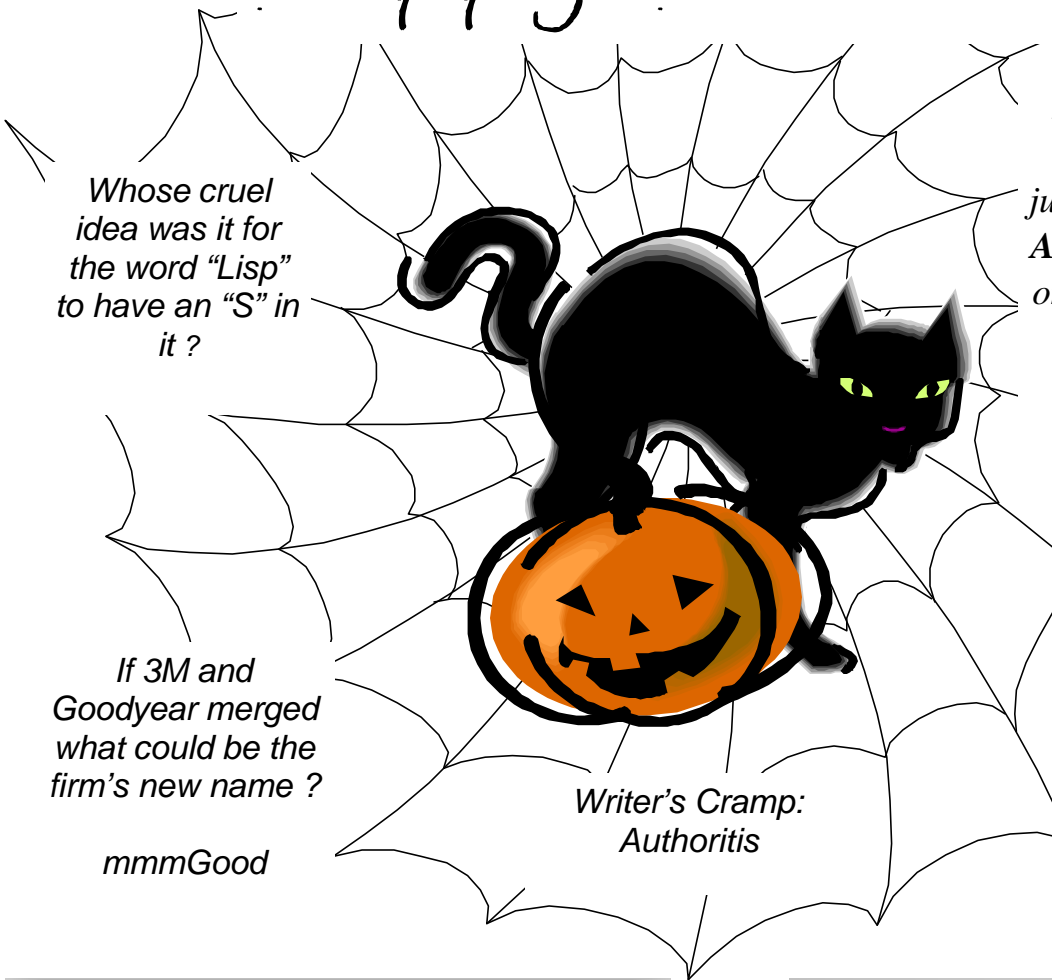
- Is training provided for new applications at set-up? Does it provide help desk support?
- Will the applications work with your current communications connection? (For optimum performance, you will need a high-speed business service such as DSL, ASDL or ISDN.)

An ASP is a way of getting the latest technology you need to run your business without the high costs and risks of developing your own IT infrastructure. The access to IT expertise and bottom-line savings could mean a significant strategic advantage.



*“McQuiggles Giggles”*

# Happy Halloween



Whose cruel idea was it for the word “Lisp” to have an “S” in it?

**Burgler:** “The police are coming! Quick ~ jump out the window !!”  
**Accomplice:** “But we’re on the thirteenth floor!”  
**Burgler:** “This is no time to be superstitious!”

If 3M and Goodyear merged what could be the firm’s new name?

No matter how limited your vocabulary is, it’s still big enough to let you say something you’ll later regret!

mmmGood

Writer’s Cramp:  
 Authoritis