The Barrington

Partner Report

BARRINGTON
WEALTH PARTNERS INC

SPRING 2005

A message from our President

2005 will be our break through year!

Paul Brown

Welcome to our first edition of The Barrington Partner Report! We are excited about the opportunity for all of our members to communicate and share ideas. 2005 is going to be a break through year for BWP as we continue to grow our enterprise and introduce new services.

Barrington is owned and operated by its member firms which makes us a unique distribution company in the financial services industry in Canada. Certainly at the distribution level there has been a trend to large consolidators gathering up small MGA's and broker dealers in an attempt to build the scale necessary to compete and survive in today's market.

We see the challenge to this concept as the loss of independence for financial advisors, particularly at the high end of the market where clients demand objective advice and product offerings. There must be a clear line in the sand between distribution and product manufacturing. Despite this many firms see the key to success, particularly for corporate shareholders as the integration of product manufacturing and distribution.

Barrington provides the opportunity for shareholders to control their own destiny in the future and not to experience the conflict of interest inherent in many distribution strategies today. We will accomplish this by objectively focusing on our clients and providing "best of breed" products and advice.To do this we must aggressively grow our business model to allow us the scale to operate independently and profitably.

I will be working with all of you to accomplish this goal. Together we can build Barrington into one of Canada's pre-eminent financial services organizations. I know that every Barrington member shares this vision with me and that "together . . . we're better!" **B**

ZLC Private Investment Management doubles in size

By Carrie Lyle, B.Comm, MBA, CMA Vice-President, Portfolio Manager

Carrie Lyle

ZLC Private Investment Management (ZLC PIM) was launched in April 2000 as a joint venture between Zlotnik, Lamb & Company (ZLC) and Vertex One Asset Management (Vertex), a Vancouver-based investment manager.

Despite a viable retail mutual fund business, ZLC felt that professional "in-house" money managers would be best suited to service and retain portfolios in the +$1 million range.

From the beginning, ZLC PIM's focus has been on portfolios of $250,000 and above, positioning us as both the high-end asset management division of ZLC and primary arm of Vertex.

When I first joined ZLC in June 2002, ZLC PIM had $25 million and less than 100 clients. Fast track almost three years later and ZLC PIM is almost at $120 million with close to 400 clients. Our success has been largely attributable to our relationship with Vertex, which continues to represent close to 90% of assets under management.

From 1993 to 1997, the Vertex founders worked together at M.K.Wong, a well-known Vancouver-based money manager. M.K. Wong was responsible for managing the domestic equity portfolio for HSBC.

In 1997, HSBC acquired M.K. Wong and the services of John Thiessen, CFA who was one of the top talents. HSBC asked John to head-up its New York trading desk. Not wanting to pursue a career in banking, John rejected the offer and set up his own shop, Vertex, with several associates.

The idea for a proprietary fund had been talked about for some time by the Vertex founders. Their vision was to create a structure where institutional strategies could be packaged and made available to the individual

(cont. on page 4)

Is your shareholders' agreement adquately funded?

By Deborah Goch, CA, TEP, Tax Advisory Group

Deborah Goch

Perhaps one of the most essential tools for business owners is the shareholders' agreement—the agreement that governs the management and operation of the company and the share transfer provisions. A well-written shareholders' agreement can make the transition from one owner to the next much easier. A poorly written shareholders' agreement can cause conflict between shareholders. In extreme cases, it can even place the survival of the business itself into jeopardy.

An important consideration surrounding transfer of share ownership is funding. This issue is of particular importance in the event of the untimely death of a shareholder. Who will assume ownership of the deceased owner's shares – will it be the surviving spouse or other family members, the remaining shareholders or will the shares be sold to a third party?

The family of the deceased shareholder may not wish to own the shares but may prefer to sell the shares for their fair market value. The family may have a significant need for liquidity to replace the income of the deceased shareholder or to pay final taxes related to his or her shares and other property.

When the shareholders' agreement calls for the remaining owners to acquire the business interest of the deceased, where will the money come from to buy that interest?

Generally speaking, it's cheaper to buy a business with corporate dollars rather than personal dollars. But how can a growing business fund a shareholder buyout without putting itself into financial difficulties? In addition, the tax implications can differ significantly depending on the type of buy-sell arrangement used.

Four options

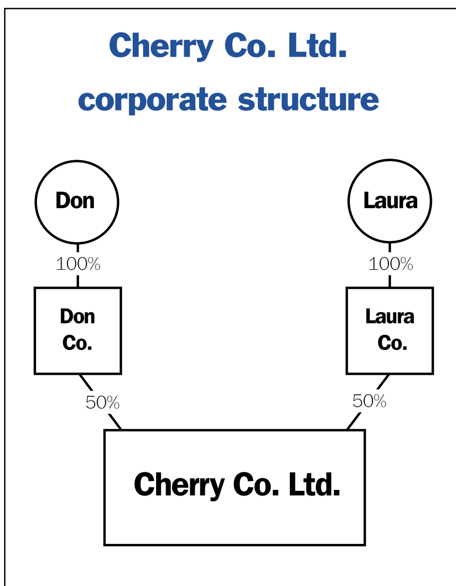
Typically owners face four alternatives for funding:

(a) fund the purchase with cash on hand;
(b) fund the purchase with future profits of the business;
(c) take out a loan;
(d) use life insurance to fund the purchase.

Let's use a case example to consider the amount of corporate dollars required to return each $1 (net of taxes) to the Estate for these alternatives.

The Case of Cherry Co. Ltd.

Don and Laura are in the owners of Cherry Co. Ltd., with each owning 50% of the shares indirectly through individual holding companies, DonCo and LauraCo (see chart below).



Don is 52 years old and Laura is 45 years old; both are non-smokers. The fair market value (FMV) of Cherry Co. Ltd. is 5,000,000.

One day Don suffers a fatal heart attack. The value of his interest in Cherry Co. Ltd. is $2.5 million. Under the terms of their shareholders' agreement, the shares of Cherry Co. Ltd. owned by DonCo will be sold to LauraCo. Don's estate plans to wind-up DonCo immediately following the sale. In this case, the resulting combined corporate and final personal tax for Don's estate will be approx. $600,000. This means his estate will retain only $1,900,000. But how many corporate dollars will it take to return each $1 (net of taxes) to Don's estate?

Purchase with cash on hand: $1.31 for every $1.00 to Don's estate

If there was cash on hand of $2,500,000 to fund the purchase of Don's interest in Cherry Co. Ltd. as described above leaving Don's estate with $1,900,000 of capital after taxes, this means it would take corporate assets of $1.31 to fund every $1 flowing to Don's estate.

Future profits: $1.60 for every $1.00 to Don's estate

Alternatively, LauraCo could fund the purchase of Don's interest with future company profits received from Cherry Co. Ltd. If Cherry Co. Ltd. earned annual income of $400,000 eligible for the small business deduction tax rate of 18%, it would have sufficient after-tax earnings to fund the installment purchase of Don's interest over an 8-year period. To provide the required capital of $2.5-million, Cherry Co. Ltd. would need to earn total pre-tax income of $3.05-million over eight years. In other words, the company must come up with $1.60 in earnings for every $1 flowing to Don's estate. Assuming a 15% sales margin, that means corporate revenues of more than $20-million would be required over that period.

Borrow funds: $2.16 for every $1.00 to Don's estate

If the company has exceptional credit with its bankers, LauraCo could choose to borrow funds for the purchase. If the company arranges a loan of $2.5-million at a 7.5% interest

(cont. on page 3)

rate to be repaid over 10 years, the company will pay $1,061,000 in interest over that period. Assuming that the interest expense is tax deductible, that means pre-tax corporate earnings of $4,111,000 are needed to provide the required corporate capital of $2.5 million. In other words, LauraCo will need $2.16 for every $1 flowing to Don's estate.

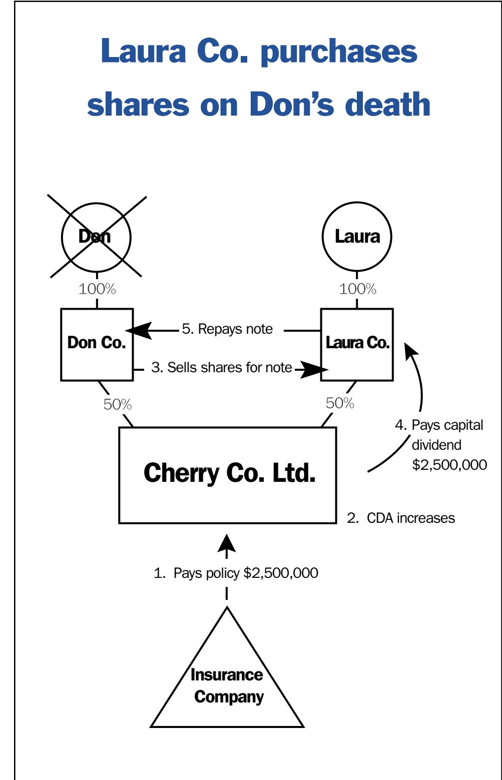
Life insurance: Up to 2 cents for every $1.00 to Don's estate

Corporate-owned life insurance offers another funding option. For example, in Don's case the annual premium on a $2.5 million insurance policy would be $5,900 for 10-year term and $29,700 for a Term-to-100 policy. For Laura, the cost would be $2,225 and $12,800, respectively. The corporate earnings needed to fund such an expenditure for Don would be $7,195 for Don's 10-year term and $36,220 for the Term-to-100 policy. That amounts to an annual cost of one-half of one cent to 2 cents for every $1 returned to Don's estate.

Needless to say, this is much less expensive than the other options. But cost is only one factor to consider. Life insurance also results in immediate liquidity for Don's estate, while boosting the capital dividend account balance for Laura's holding company by $2,500,000, allowing future profits of up to that amount to be paid tax-free to her in the future.

Of course, the needs of one shareholder may not be the same as the needs of another. Which is why it makes sense for shareholders to seek expert advice on funding and tax considerations before drafting their shareholders' agreement.

The TAG Team at Barrington Wealth Partners can help design a shareholders' agreement that's tax effective and adequately funded, and in so doing, help prevent one of the most common problems that can arise from business ownership. **B**



Tax Advisory Update

Interest deductibility for 8%/10% loan strategies under scrutiny

A recent Technical Interpretation (document no. 2004-0065531E5) issued by Canada Revenue Agency (CRA) raised the issue of interest deductibility in respect of certain policy loan arrangements. It described a policy loan strategy where a fixed 2% spread was guaranteed between the investment return in the policy and the loan interest rate.

The writer assumed that a commercial loan rate was 5% for this type of loan and so a 3% rate was offered on the investment account. There were no other loan terms or limitations specified. The writer then asked CRA how they would view the same situation if the loan interest rate on the "same type" of arrangement was instead 10% resulting in an 8% investment rate in the policy.

Not surprisingly, CRA replied, "Clearly the intent of the increased rates is to attempt to provide the policyholder with an increased deduction for interest…and an increased return under the policy on a tax deferred or the exempt basis. However, in order for interest to be deductible…the amount of interest that has been paid or is payable must be reasonable in the circumstances."

Several loan arrangements in the marketplace could be the target of this request, for example, the fixed rate policy loans (FRPL) offered through PPI and Transamerica's Investment Loan Strategy. It could also be applicable to PPI's Investment Credit Facility (ICF).

So what interest rate would be reasonable? PPI has prepared a response to this Technical Interpretation that is posted on its advisor website which contains a good discussion of this issue and defends the interest rates used in their FRPL and ICF strategies.

For a copy of the Technical Interpretation or the PPI response, please contact Deborah Goch, CA, TEP at dgoch@zlc.net or (604)688-7208. **B**

Your TAG Team:

Ed Lapointe - elapointe@bwpartners.com

Mark Zlotnik - markz@zlc.net

Christine Black - cblack@arcafinancial.com

Deborah Goch - dgoch@zlc.net

Private Investment Management (from page 1)

investor. The strategies would be focused on absolute returns and aimed at minimizing market risk. And they wanted to do it differently.

The Vertex Funds incorporate performance-based fees, so that investors will not be paying for non-performance. The Vertex fund managers invest all their personal portfolio dollars in their own funds which allows them to avoid the conflict so common in the industry. They also limit their product offerings, so that their focus remains on key day-to-day investment decision- making.

The partners had always been very good at managing money. In February 1998, with $30 million, the Vertex Hedge Fund (inception: 25.88%) was introduced. Today, the Vertex Hedge Fund accounts for close to $350 million in assets. When Vertex Fund was launched, it was one of only 10 hedge funds in Canada; today there are over 200.

Although we're just beginning to open up our referral network to members of Barrington, we've already seen about $2 million from an active advisor in Ontario. Members of Barrington share in the same referral arrangement offered to our ZLC associates.

Looking ahead, we've already begun discussions with a new money manager with a U.S. equity product. They are just starting out and in need of a distribution channel, somewhat similar to the Vertex situation some 5 years ago. Demand is growing for our approach to investment management, and this year's ambitious target of $200 million doesn't seem that far away.

For more information, feel free to contact me directly at (604) 685-1096, or email me at clyle@zlc.net. **B**

Contact us

Barrington Wealth Partners Inc.
200 Waterfront Drive, Suite 244
Bedford, NS B4A 4J4
Tel: 902.832.9797
Fax: 902.832.9779

Head office contacts:
Paul Brown - President & CEO (1.866.816.4902)
Theresa Crozier - Executive Assistant (1.800.663.1499 ext. 346)
Kim Gray - Operations Manager (1.866.810.0115)
Jeff Coulter - MGA Coordinator (1.866.390.9931)
Deborah Goch - Editor (1.800.663.1499 ext. 231)

Our member firms

Zlotnik, Lamb & Company
1200 Park Place
666 Burrard St.
Vancouver, BC V6C 2X8
Tel: 604.688.7208
Fax: 604.688.7268
Toll Free: 800.663.1499

Robert E. L. Trowbridge
2338 Park Place
666 Burrard St.
Vancouver, BC V6C 2X8
Tel: 604.689.8289
Fax: 604.689.2801

Fauth Financial Services Inc.
115 Sierra Morena Court SW
Calgary, AB T3H 2X8
Tel: 403.237.9990
Fax: 403.263.5259

ARCA Financial Group Inc.
237 Labrador Drive
Waterloo, ON N2K 4M8
Tel: 519.745.8500
Fax: 519.745.8283

The Gill Planning Group Inc.
4128-2025 Sheppard Ave. E
Toronto, ON M2J 1V6
Tel: 416.492.4455
Fax: 416.492.5591

The TK Insurance Group Inc.
100-800 Lady Ellen Place
Ottawa, ON K1Z 5L9
Tel: 613.728.7030
Fax: 613.728.6005

Groupe Brissette Inc.
420-1 Westmount Square
Montreal, PQ H3Z 2P9
Tel: 514.932.7890

McHugh Group
420-1 Westmount Square
Montreal, PQ H3Z 2P9
Tel: 514.840.8899
Fax: 514.840.8890

Lengvari Financial
1 Place Ville Marie
Montreal, PQ H3B 2C3
Tel: 514.871.1808

BWP Advisory Services Inc.
244-200 Waterfront Drive,
Bedford, NS B4A 4J4
Tel: 902.832.9797
Fax: 902.832.9779

Pippy Financial Services Inc.
710-100 New Gower Street
St. John's, NF A1C 6K3
Tel: 709.579.4700
Fax: 709.579.3633

Barrington Wealth Partners is a national financial services firm that specializes in providing high net worth clients with a combination of risk management and objective product analysis and implementation.