CLU 256

Tax & Legal Principles for Businesses and their Owners

CLU Program

Important Disclaimer:

This publication is designed to provide accurate and authoritative information about the subjects covered. While every precaution has been taken in the preparation of this material, the authors and Advocis assume no liability for damages resulting from the use of the information contained in this publication. Advocis is not engaged in rendering legal, accounting, or other professional advice. If legal, accounting, or other professional advice is required, the services of an appropriate professional should be sought.

About The Institute for Advanced Financial Education™

The Institute for Advanced Financial Education™ ("The Institute") is the leading designation body in Canada for financial services practitioners in the specialty areas of advanced estate and wealth transfers, and living benefits.

The Institute provides a platform of standards and advanced knowledge through designation programs and accreditation services. The Institute boasts more than 4,500 CLU® and CHS designation holders.

Relationship to Advocis, The Financial Advisors Association of Canada

Advocis, The Financial Advisors Association of Canada, is the oldest and largest voluntary professional membership association of financial advisors and planners in Canada. We are the home and the voice of Canada's financial advisors. For over a century, Advocis has proudly served Canadian financial advisors, their clients and the nation.

The Institute operates as the standards setting and designation body for Advocis, The Financial Advisors Association of Canada, and remains a member of the TFAAC family. The Institute focuses on setting standards for the designations and education world, and serves as the enforcement body for both Advocis' and The Institute's codes of professional conduct.

CLU Program, 2019 Edition

The Institute™, The Institute for Advanced Financial Education™ and the CLU® are trademarks of The Institute for Advanced Financial Education. Advocis® is a trademark of The Financial Advisors Association of Canada.

Copyright © 2019. The Institute for Advanced Financial Education. All rights reserved. Unauthorized reproduction of any images or content without permission is prohibited.

Acknowledgements

Our sincere thanks to the course authors who so generously contributed their time and expertise:

James W. Kraft, CPA, CA, MTAX, TEP, CFP, CLU, FEA. James is Estate & Insurance Advisor, Vice President, BMO Estate Insurance Advisory Services Inc.

Deborah Kraft, MTAX, LLM, TEP, CFP, CLU, CH.F.C. Deborah is Faculty and Director, Master of Taxation Program, School of Accounting & Finance, University of Waterloo

With contributions from L.J. Swartz, J.D., CLU, CFP, CH.F.C., TEP, CFA, Andrew Zur, B.Sc., LL.B., and Lois Gottlieb, Ph.D., J.D.

Course Objectives

This course focuses on wealth transfer and estate planning strategies for businesses and business owners. The course includes:

- A description of the legal and tax implications of certain business structures, specifically sole proprietorships, partnerships and corporations with particular attention to tax planning strategies and the issues to be addressed at the sale or transfer of the business or at the death of a principle;
- A special focus on the tax complexities present in the operation of a corporation;
- The approaches to identify, apply and synthesize appropriate income tax techniques used to restructure a corporation;
- The consideration of planning strategies for the orderly and tax-efficient distribution of business wealth at retirement or upon death.

Course Outline

Candidates have 120 days from the date of registration to complete this course. The course is divided into four separate modules.

Module	Topics Covered
Module 1: Tax Concepts for Sole Proprietorships, Partnerships & Private Corporations	Entities Taxation of Partnerships Definitions & Corporate Relationships
Module 2: Tax Planning for Private Corporations & Their Shareholders	Corporate Taxation Capital Dividends Capital Gains Exemption Shareholder Remuneration & Benefits
Module 3: Tax Applications for Business Restructuring & Transitions	Business Structuring Corporate Attribution Buy-Sell Arrangements
Module 4: Succession Planning for the Disposition of a Business Interest	Estate Freeze Succession Valuation of a Corporation Corporate-Owned Insurance – Valuations

Table of Contents

Module 1: Tax Concepts for Sole Proprietorships, Partnerships & Private Corporations 1
- Entities 2
  - Sole Proprietorship 3
  - Partnership 8
  - Corporations 11
  - Holding Company 20
  - Professional Corporation 20
- Taxation of Partnerships 22
  - General Partnerships 23
  - Limited Partnerships 23
  - Limited Liability Partnerships 24
  - Fiscal Period of a Partnership 25
  - Taxable Income of Partnerships & Partners 25
  - Adjusted Cost Base 28
  - Partnership Property 32
  - Withdrawal or Retirement of a Partner 32
  - Wind-Up of a Partnership 37
  - Uses of Limited Partnerships 39
- Definitions & Corporate Relationships 42
  - Canadian Corporation 42
  - Residence of a Corporation 43
  - Public Corporation 43
  - Private Corporation 44
  - Canadian-Controlled Private Corporation (CCPC) 44
  - Small Business Corporation (SBC) 45
  - Control 46
  - Relationships 47
  - Dividends 53
  - Adjusted Cost Base 56
  - Paid-Up Capital 56

Summary 59

Module 2: Tax Planning for Private Corporations & Their Shareholders 1
Corporate Taxation 2
Taxation of Corporations 2
Taxation Year – Fiscal Period 2
Types of Income 3
Federal Tax Rates 7
Dividends 13
Provincial Corporate Taxes 17
Filing of Tax Returns 20
Tax Instalments 20
Balance Due Date 21
Theory of Integration 21
Capital Dividends 26
Components of the CDA 27
Integration of Components 28
Calculating the CDA 29
Life Insurance Proceeds 29
CDA Election 30
Penalty Tax 31
Timing of a CDA Payment 32
CDA Recap 33
Timing of the Credits 33
Capital Dividend Trapped by Circumstances 34
Capital Gains Exemption 36
CGE Limits 36
Calculation of Additional Exemption 37
Capital Gains Deduction 38
$100,000 CGE 39
CGE Today 40
Residency Requirements 42
Converting Business Assets into Shares of a QSBC 43
Dispositions for Tax Purposes 46
Cumulative Net Investment Losses 47
Allowable Business Investment Losses 49
Alternative Minimum Tax 50
Crystallizing CGE 51

Shareholder Remuneration & Benefits 56
Salary versus Dividends 56
Benefits 59
Shareholder Benefits 61
Loans to Shareholders 64
Summary 69

Module 3: Tax Applications for Business Restructuring & Transition 1
Business Structuring 2
Section 85 2
Section 86 15
Comparison of Section 85 & Section 86 18
Internal Section 85 Transfer 19
Section 51 Conversion 22
Corporate Attribution 23
A Penalty Provision 23
The Conditions 24
Purpose Test 24
Designated Person 25
Specified Shareholder 25
Deemed Income 27
Outstanding Amount 28
Marriage Breakdown 28
Safe Harbour Provision 29
Buy-Sell Arrangements 30
Buy-Sell Provisions 30
Changing Trends 31
Buy Sell Agreements 36
Criss-Cross Method 37
Promissory Note Method 43
Redemption Method 49
Comparison 56
Hybrid Method 58
Spousal Rollover 65
Disability 66
Stop-Loss Rules 68
Conclusion 69
Summary 70

Module 4: Succession Planning for the Disposition of a Business Interest 1
Estate Freeze 2
The Concept of an Estate Freeze 2
Factors of an Estate Freeze 3
Choosing an Estate Freeze 4
Techniques 4
Freezing Personally-Owned Assets 9
Refreezing the Freeze 10
Partial Freeze 12
Systematic Redemption 13
Succession 17
Succession: The Casting Call 17
Different Interests 19
Business Transfer: Making Decisions, Outcomes & Risks More Manageable 21
To Sell or Not to Sell – The Age-Old Question 24
Family Transition by Chance, Choice or Necessity? 27
Succession Planning: Let’s Make a Deal 31
Share Sale & Asset Sale 33
Case Study: Business Emergencies can be Planned For 35
Valuation of a Corporation 40
Transactions 40
Fair Market Value 42
Valuation 43
Integration into a Shareholders’ Agreement 46
Shareholder Relationships 49
Price Adjustment Clause 51
Corporate-Owned Insurance – Valuation 55
Statutory Provisions 55
Normal Valuation Principles 57
Buy/Sell Arrangements 60
Capital Gains Exemption 61
Summary 64

Module 1: Tax Concepts for Sole Proprietorships, Partnerships & Private Corporations

Learning Objectives

Upon completion of this module, you should be able to:

- Analyze different types of entities through which a business may be carried on, and propose a particular structure to address a client's specific objectives;
- Apply and synthesize general legal and business concepts associated with a corporate business structure;
- Analyze and explain the significant income tax consequences associated with a partnership structure;
- Understand and apply the series of terms and relationships used extensively in the application of corporate taxation.

Copyright © 2019 The Institute for Advanced Financial Education.

Entities

The three major types of structures under which businesses operate are sole proprietorships, partnerships, and corporations. A sole proprietorship involves a single individual conducting business on her own behalf. Partnerships involve one or more persons who conduct business together and include limited partnerships and limited liability partnerships. A corporation is a legally distinct entity that conducts business, pays taxes, and can be bought and sold.

Common law is the original source of business organizations law. Historically, businesses were operated either as sole proprietorships or partnerships, which were governed primarily by contract law. Contract law still plays an important role in business, as it can have implications for a business organization in the relationships it has with other businesses, with investors, and with customers. Many business contracts are also affected by statutes and regulations.

Business organizations are also affected by the common law rules that impose fiduciary duties in certain circumstances. For example, partners of a partnership, and directors and officers of a corporation must act with loyalty and good faith toward the partnership or corporation they serve. This includes acting in the best interests of the business, directing any related business opportunities they find to the partnership or corporation and avoiding conflicts of interest.

When a partner or director has a conflict of interest with a partnership or corporation or has personal dealings with a partnership or corporation, conflicts must be disclosed and steps taken to protect the business.

Each province has legislation governing partnerships (a Partnership Act), as well as business corporations (a **Business Corporations Act**). In a given jurisdiction, one statute may cover all partnerships, or there may be separate acts for limited partnerships and limited liability partnerships. The same applies for corporations, with statutes distinguishing between public and private corporations. Non-profit corporations are not considered businesses and are governed by separate legislation.

Some corporations, such as long-established life insurance companies, are created by a specific act of parliament or legislature, as are some non-

Copyright © 2019 The Institute for Advanced Financial Education.

business corporations, such as universities, hospitals, and religious organizations.

The organization of a business is significantly affected by the potential taxes it pays on profits earned and related taxes. Sole proprietorships, partnerships, and corporations are all treated differently for tax purposes. The owners of a business may want to change the organization of the business to minimize overall taxes or to meet business needs or facilitate a change in ownership. Tax law is complex and frequently changing, so a business of any size needs appropriate tax, accounting, and legal advice.

Businesses are also affected by other sources of law. For example, legislation and regulations affect the conduct of most types of businesses and may impose duties and responsibilities on directors, officers, and managers. **Bankruptcy** and insolvency law becomes relevant for companies in financial distress and may result in the reorganization, sale, or dissolution of a business. Some businesses are subject to specific legislation aimed at their particular industry.

Sole Proprietorship

A **sole proprietorship** is the most basic type of business organization. In this business structure, an individual personally conducts business, and any contracts or debts of the business are the personal responsibility of the individual. Because the sole proprietor's business profits and losses go directly to the individual's income tax return, this type of business structure is considered a flow-through entity for Canadian tax purposes. A sole proprietor is subject to personal liability for the debts of the business.

Copyright © 2019 The Institute for Advanced Financial Education.

Starting & Registering a Business

A sole proprietorship is the easiest way to start a business. A sole proprietor can conduct business immediately without paying the cost of incorporating or operating a corporation, although a business license may be required. A sole proprietorship that conducts business using a name other than the owner's must register that name with the provincial government. Registering a business name requires a computerized business names search as well as an application to the government.

Taxation

The direct taxation of sole proprietorships can be an advantage for a small business, particularly in its early years. A sole proprietor avoids the cost of preparing corporate tax returns, although he or she should still consider hiring a professional bookkeeper to keep track of revenues and expenses. If not exempt, the business should obtain a business number and a HST/GST (harmonized/goods and services tax) number and should remit all sales, payroll, and income taxes on time to avoid penalties.

EXAMPLE

Frank wants to set up an import-export business and decides to begin the business as a sole proprietorship. Frank's first few years of operation produced the following results.

	Year 1	Year 2	Year 3	Year 4
Gross Revenues	$10,000	$100,000	$250,000	$500,000
Expenses	$50,000	$150,000	$200,000	$220,000
Net Profit/ (Loss)	($40,000)	($50,000)	$50,000	$280,000

A benefit arising from a sole proprietorship approach is the ability to claim losses against personal income. This is particularly valuable for many new businesses in the start-up phase when losses tend to be more common. In years one and two, Frank would be able to claim the business losses realized against his other income, which is reported on his personal tax return.

Copyright © 2019 The Institute for Advanced Financial Education.

In year three, the business income would increase Frank's total income by $50,000. Depending on his other sources of income, this could push his total income into higher levels of taxation.

In year four, when the business operation is generating substantial revenue, the $280,000 of net profit from the proprietorship would be added into Frank's total income for that tax year. Frank would have to declare the entire $280,000 on his tax return and pay the resulting personal taxes based on the total income earned.

Business Losses

A sole proprietor's business losses can be deducted from other income so long as the business is not considered the owner's hobby. Losses arising from an activity such as a hobby, generally, have no expectation of profit and cannot be deducted from income. The Supreme Court of Canada has ruled that a business can have a reasonable expectation of profit, even if it produces sustained losses, as long as it is carried on in a commercial manner and the activity is not a personal endeavor.

In the early years of a small business, particularly if conducted on a part-time basis, the deductibility of losses against an individual's other income can be a key advantage. Expenses must be related to the cost of earning revenue. A home-based business can deduct the cost of a home office and other business expenses from revenue when computing income, although amounts deducted must be justifiable.

A sole proprietorship cannot defer taxes or distribute profits to shareholders in the same way as a corporation. Furthermore, a sole proprietorship does not receive some of the tax advantages granted to Canadian corporations, such as the small business tax rate and the small business Lifetime Capital Gains Exemption (LCGE).

Copyright © 2019 The Institute for Advanced Financial Education.

Liability

A sole proprietor is directly responsible for debts incurred by the business. Once the business develops substantial assets, incurs debts, and hires employees, personal liability may become more of a concern. A sole proprietor may be able to reduce personal liability by purchasing appropriate insurance or implementing certain creditor proofing strategies but should consider seeking the advice of legal and financial advisors before pursuing a strategy.

Copyright © 2019 The Institute for Advanced Financial Education.

Summary

Many of the advantages and disadvantages of using a sole proprietorship arrangement as a form of business structure are summarized in the following table:

Sole Proprietor		
Issue	**Advantages**	**Disadvantages**
Ease of formation	Yes	
Start-up costs	Nominal	
Working capital required	Nominal	
Regulation	None	
Legal restrictions	None	
Control by owner	Complete	
Prospects for continuity		Very limited
Management base	Owner	
Management conflict	None	
Record keeping	Nominal	
Transfer of ownership		Difficult
Tax advantages	Moderate	Moderate
Profits	All to owner	
Personal liability		Unlimited
Ability to raise capital		Very limited

Copyright © 2019 The Institute for Advanced Financial Education.

Partnership

A **partnership** is a common form of business structure used in Canada today. A partnership permits two or more persons to carry on business together on an ongoing basis and share the profits and risks of the undertaking. A partnership may be a combination of individuals and/or corporations. For example, two individuals, an individual and a corporation, or two corporations are all examples of groups that could form a partnership.

Partnerships are flow-through business entities for income tax purposes (similar to proprietorships), with all net profits and losses from the partnership being taxed pro-rata in the hands of the individual partners, according to the partnership agreement. Without a partnership agreement, net profits would be shared equally.

However, unlike proprietorships (where all income and expenses are reported on the sole proprietor's personal income tax return), partnership income and expenses are first reconciled in the hands of the partnership; only net profits and losses are reported to the partners.

EXAMPLE

CDE Partnership realized gross revenues of $500,000 and claimed eligible expenses of $200,000, leaving the partnership with a net income of $300,000. The two equal partners of CDE Partnership would each report $150,000 of partnership income on their personal tax return.

Establishing a Partnership

Partnerships can be established with relative ease and flexibility in terms of the formation and operation of the business. The general partnership usually requires no filings with the provinces to begin operation. Many partnerships are established on an informal basis, requiring simply the voluntary association of the owners. Since the owners and managers of the general partnership are one and the same, all that is required to expand or alter the purpose of the business is their continued voluntary association. This allows

Copyright © 2019 The Institute for Advanced Financial Education.

the owners to grasp new opportunities more quickly and with fewer roadblocks than is the case with incorporated businesses. It is important to note, however, that many partnerships particularly limited partnerships – have formal agreements (similar to articles of incorporation) that may somewhat limit the flexibility of the partnership.

There are also some tax advantages associated with the operation of a partnership. First, all of partnership profits flow through to the partners, eliminating the potential for double taxation that could occur if the partnership was a separate taxable entity. Second, the partnership's operations can pass through all of its losses directly to the owners. Third, a partnership can pass through certain tax benefits, such as investment tax credits, to its partners.

A new business with substantial start-up costs and losses in the early years might find the partnership form of organization advantageous because the losses in the early years can be streamed through to the owners. This allows the partners to use operating losses to offset personal income from other sources.

General Partnership

Partners in a **general partnership** face an issue in the continuity of their business. Since the partnership requires the voluntary association of co-owners to operate the business, any termination of the voluntary nature of the relationship causes the business to dissolve. The dissolution of the partnership of those partners who want to carry on the partnership is a disadvantage because of the energy needed to dissolve one partnership and form another to carry on the business. For example, a deceased partner no longer has legal capacity to form the voluntary relationship so a partnership dissolves at the death of a general partner. In the absence of provisions or an agreement to the contrary, the business terminates at the death of any of the general partners.

A second issue with respect to operating a business enterprise as a partnership is the unlimited personal liability of each general partner for losses incurred by the partnership. This is an important consideration because each partner is held fully responsible for all of the debts and liability

Copyright © 2019 The Institute for Advanced Financial Education.

of the partnership. Each partner's personal assets may be required to satisfy partnership debts, as well as any liability incurred by other partners acting within the scope of the partnership business.

Summary

Many of the advantages and disadvantages of using a partnership arrangement as a form of business structure are summarized in the following table:

Partnership		
Issue	**Advantages**	**Disadvantages**
Ease of formation	Moderate	
Start-up costs	Low/moderate	
Working capital required	Low/moderate	
Regulation	Moderate	
Legal restrictions	None	
Control by owner		Shared
Prospects for continuity	Ongoing partners	
Management base	Junior partners	
Management conflict		Dependent on people
Record keeping		Minor
Transfer of ownership	Between partners	
Tax advantages	Moderate	Moderate
Profits		Shared
Personal liability		Unlimited
Ability to raise capital		Among partners

Copyright © 2019 The Institute for Advanced Financial Education.

Corporations

There are many reasons that a business owner might choose to operate her business as a private corporation rather than a sole proprietorship or a partnership. To create a **corporation**, the initial **shareholder(s)** would file articles of incorporation and pay a filing fee. A company can be incorporated under provincial or federal laws. Each province, along with the federal government, has a separate Business Corporations Act that would have to be complied with. The shareholder would subscribe for shares of the corporation from treasury.

Limited Liability

One of the primary advantages of the corporate form of ownership is the **limited liability** of the shareholders for the risks of business operations. A corporate shareholder's liability is limited to any capital invested in the corporation. This means a shareholder's potential loss is limited to the amount she paid for the stock. The corporation is a separate legal entity, apart from its shareholders; all liabilities of the corporation are debts solely of the corporation. Corporate debts are satisfied out of corporate property, not the shareholder's personal assets.

As much as a corporation can limit a shareholder's liability, many creditors of a private corporation will require the shareholder to personally guarantee its loans to the company. In this fashion, the shareholder can become personally liable for the debts of the corporation.

A second caveat to the corporation's ability to shield its shareholder from liability arises in professional corporations. Professionals such as dentists, doctors, veterinarians, etc. have, in more recent years, been granted permission by their professional oversight body to use professional corporations. In doing so, some professions allow a patient or client to sue the professional personally in matters of professional misconduct.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Jim, the sole shareholder of STU Inc., is pursuing bank financing to allow STU to expand into new market operations. Without new financing, STU's business reach is limited because it lacks the necessary capital.

ABC Bank is willing to lend the necessary funds but is concerned about the amount and type of assets inside STU and against which the financing will be secured. ABC Bank will lend the funds, but only if Jim personally guarantees the loan. Jim owns his home outright and has a substantial non-registered savings portfolio.

To meet the bank's request, Jim has agreed to assign his personal non-registered portfolio to the bank. While Jim's home is not affected, the risk to Jim personally is magnified because his investment portfolio will be used to satisfy the bank's claims should STU default on the bank debt. This means two significant assets – shares of STU and Jim's investment portfolio – are both a risk.

Continuity

An important advantage of the corporate form of ownership is the **continuity** provided to the business operations through the corporate entity. The corporation is a separate legal entity, distinct from its shareholders. Unlike partnerships or proprietorships, which may dissolve upon the death of the owners, a corporation continues beyond the death of a shareholder.

From a practical perspective, the death of a majority shareholder, who plays a significant role in the day-to-day business operations, can impact the viability of the business operations. However, the impact of death can be planned for with a continuation strategy, which could be outlined in the shareholders' agreement.

The key issue is that the corporate entity does not dissolve upon the shareholder's death, and a well-strategized succession plan can be put in place to ensure the continuity of business operations.

Copyright © 2019 The Institute for Advanced Financial Education.

Small Business Tax Rate - Active Income of a Private Corporation

Net active business income taxed in the hands of a Canadian-controlled private corporation qualifies for the preferred small business tax rate. This rate is a combination of both federal and provincial corporate tax rates (which vary by province) and is typically in the range of about 10 to 17 percent (combined federal and provincial) for the 2018 fiscal year. The special tax rate applies to up to $500,000 of active business income for federal purposes, net of deductible expenses (i.e. rent, salaries, bonuses, etc.). Most of the provinces match the $500,000 limit, except Nova Scotia and Manitoba, as seen in Module 2. In addition, the federal government introduced new rules that reduce the small business limit for corporations that exceed a $50,000 threshold for passive income, which will be discussed in Module 2.

Income in excess of the $500,000 threshold is taxed at the full corporate rate (ranging from 26.5 to 31 percent in the 2018 fiscal year) but will create a credit in the corporation’s General Rate Income Pool (GRIP). This will allow corporate dividends to be paid to shareholders and taxed as eligible dividends, which are taxed at a top effective marginal rate of about 30 to 40 percent (rather than the 36 to 47 percent applicable to regular, non-eligible dividends).

The rules dealing with the taxation of active business income in excess of the threshold will be addressed in Module 2 of this course.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

John is a successful entrepreneur operating as a sole proprietor. He is considering the possibility of changing structures under which the business operates and is pondering the pros and cons of a corporation compared with a proprietorship. An aspect of John's assessment is the overall income tax liability arising on business profits and the amount of after-tax profit available to save and/or re-invest into business operations.

John is projecting business operations will earn $300,000 of net income. Below is a comparison.

Financial Comparison		
	Sole Proprietor ($)	Corporation ($)
a. Corporate income		300,000
b. Salary to shareholder		190,000
c. Personal taxable income	300,000	190,000
d. Personal income taxes	120,000	65,000
e. After-tax position	180,000	125,000
f. Lifestyle needs	120,000	120,000
g. Available for saving (e – f)	60,000	5,000
h. Corporate taxable income (a – b)		110,000
i. Corporate income taxes		13,200
j. Available for saving (h – i)		$96,800

In this comparison, John has over 50 percent more after-tax cash flow to save or reinvest back into the business under the corporation option [$96,800 (j) versus $60,000 (g)]. The primary reason for such a significant difference is low corporate tax rates. The corporation pays a much lower rate of tax than an individual, leaving the corporation with funds for reinvestment.

Copyright © 2019 The Institute for Advanced Financial Education.

Tax rates for corporations are generally lower than those for individuals. In addition, the federal and provincial tax laws allow a very low rate of tax on the first $500,000 of active business income. A lower tax rate means more after-tax income to fund the needs of the business. Alternatively, a corporation can accumulate its after-tax income in conventional non-registered portfolios (although tax rates may be affected). The federal government introduced new rules that impact corporations that accumulate significant amounts of investment income. Discussions about these rules will follow in subsequent sections.

Income Tax Advantages of Corporate Structure

A corporate structure offers the owner (shareholder) the following income tax advantages:

- **Access to the small business deduction**, which provides for a very low rate of tax on the first $500,000 of active business income. This results in more after-tax business profits.
- **The availability of the capital gains exemption**, which allows the first $866,912 (2019 amount) of capital gain realized on the disposition of shares of a qualified small business corporation to be realized tax-free.
- **Income splitting** may be achieved in some circumstance by the sprinkling of dividends among certain adult family members with the goal of lowering the family's overall income tax liability. The tax on split income rules (TOSI) have limited traditional income splitting opportunities effective for 2019 onward. The TOSI rules were discussed in course 255.

Cost of Non-Deductible Insurance Premiums

When circumstances allow a choice between owning an insurance policy personally or within a corporate structure, the fact that corporate tax rates are lower than personal tax rates can make it more efficient for the shareholder to fund the life insurance premiums through a corporation. Since life insurance premiums are an after-tax expense, it makes sense for the entity in the lowest tax bracket to fund the premiums.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Lynda, the owner of an active small business corporation, wants to fund her $12,000 per annum life insurance premiums. Lynda's personal marginal tax bracket is 45 percent, while her company's tax rate on its active income is 15 percent. The following is a financial comparison to show the cost of owning the policy personally versus through the corporation.

Cost Comparison: Personally Owned vs. Corporate-Owned		
	Personally Owned	Corporate-Owned
a. Required gross income to support the life insurance premium	$21,818	$14,118
b. Estimated income tax liability on the income in (a) above	$9,818	$2,118
c. After-tax position (a – b)	$12,000	$12,000

In the above chart, the formula for determining the gross income required to support the life insurance premium is:

(Total premium dividend) ÷ (1 – (taxpayer's tax rate))

If Lynda owns her life insurance policy in her corporation, she will have to take the necessary steps to ensure that her estate plans reflect this approach. Upon her passing, as beneficiary of the life insurance policy, the corporation will receive the insurance proceeds. Lynda could stipulate that her executor is to cause the corporation to pay a dividend to the estate, electing the maximum capital dividend amount, in order to minimize income taxes.

Tax Deferral

The small business tax rate is particularly attractive for those business owners who do not need to withdraw all of the annual net active business income from the business. Because of the low small business rate (normally much lower than the personal tax rate of the owner), more after-tax capital is available for business use or investment inside a Canadian-controlled private corporation than through a proprietorship or partnership.

Copyright © 2019 The Institute for Advanced Financial Education.

Example

Baxter is in the top marginal tax rate (roughly 50 percent), and his business generates $350,000 of taxable income. Baxter requires $150,000 of pre-tax income to maintain his standard of living.

If Baxter operates his business as a sole proprietorship, the $200,000 of excess active business income ($350,000 less $150,000 = $200,000) will be taxed in his hands at his 50 percent personal rate. He will have to pay federal and provincial taxes of roughly $100,000 on the $200,000 of "excess" income, leaving only $100,000 for business use or investment.

On the other hand, if the $200,000 of 'excess' active business income is earned and retained within a small business corporation, it will be subject only to the small business rate of roughly 15 percent, resulting in only $30,000 of corporate taxes payable. This will leave about $170,000 (compared with $100,000) available for business use or investment.

The following chart depicts the compounding effect where excess profits are available under a proprietorship and a corporate structure. The chart looks at the value of the investment at the end of five years, assuming:

- After-tax excess revenue can be invested to generate five percent (both inside and outside a private corporation) growth; and,
- Investment income earned by a corporation is taxed at about 50 percent. While some of the corporate tax is refundable, it is not refundable until taxable dividends are paid.

Compounding Effect		
	Proprietorship	Corporation
Excess net profits	$200,000	$200,000
Applicable tax rate	50%	15%
Income taxes payable	$100,000	$30,000
After-tax amount	$100,000	$170,000
Net income earned over 5-year period at 5% compounded annually (after-tax)	$13,140	$22,339
Investment value year 5	$113,140	$192,339

Copyright © 2019 The Institute for Advanced Financial Education.

Passive Income

If the business owner requires all of the income to meet lifestyle needs, there would be a **flow-through** of the income from the business to the shareholder using dividend taxation. When income flows through the corporation and directly out to the shareholder as a taxable dividend, there is no significant financial benefit derived from using a corporate structure when compared with a proprietorship.

Probate

Upon the death of an individual, a probated will is required in order to transfer the title of many types of property. This necessitates the probating of the deceased's estate, which includes filing the necessary paperwork with provincial authorities resulting in public disclosure of many financial details.

On the death of a shareholder of a private company, the executor can affect a transfer of shares by requesting the lawyer to record such a transfer in the minute book of the corporation. A copy of probate is not necessary for changing the ownership of the shares.

Organizational Formalities

There are organizational formalities and processes required in a corporate structure that must be adhered to. These include:

- Incorporation of the company is a formal filing process that has a cost.
- Administratively, a corporation must maintain a minute book reflecting decisions of the corporation, minutes of shareholder meetings, and minutes of director meetings.
- The corporation will have its own tax return that must be filed annually.
- A corporation's income tax liability is due within two months of year-end, or three months for a CCPC. The corporation may be required to make income tax installments.
- A corporation generally necessitates the engagement of professional accountants and lawyers to assist in certain aspects of the corporation's administration.

Copyright © 2019 The Institute for Advanced Financial Education.

Summary

Many of the advantages and disadvantages of the corporate form of business structure are summarized in the following table.

Corporation		
Issue	**Advantages**	**Disadvantages**
Ease of formation		No
Start-up costs		Relatively high
Working capital required		Relatively high
Regulation		Significant
Legal restrictions		Significant
Control by owner	Shareholders	
Prospects for continuity		Yes
Management base	Shareholders	
Management conflict	Possible	
Record keeping		Extensive
Transfer of ownership	Relatively easy	
Tax advantages	Significant	
Profits	All shareholders	
Personal liability	Limited	
Ability to raise capital	More flexible	

Copyright © 2019 The Institute for Advanced Financial Education.

Holding Company

A holding company is simply an ordinary corporation that owns another corporation. Holding companies are used for many reasons, some of which include:

- To hold one or more different operating companies. A single holding company may hold the shares of several different operating companies. For example, the operating companies may be in different industries or different geographic locations. On the other hand, multiple operating companies may be used to provide creditor protection from each other, with the holding company being the parent of each.
- To hold an interest in an operating company. Multiple shareholders who own the same class of shares must all receive dividends when paid on that particular class of shares. Yet, each shareholder may have a different financial plan – some may want to accumulate dividends in a corporation (i.e. compounding effect), while others may want the income for lifestyle. Multiple holding companies, each owned by a different shareholder, provide flexibility to shareholders to deal with dividends received from the operating company in a way that suits his or her particular objectives.
- To hold select assets used by the operating company. In an effort to enhance creditor protection, a holding company is commonly used to own any land, buildings, and equipment of the operating company. By shifting select assets to the holding company, it reduces the asset value in the operating company, thereby leaving fewer assets within reach of the operating company's creditors.

Professional Corporation

A professional corporation is simply an ordinary corporation that is operated by a professional and approved by the professional's regulating body. Examples of common professions that allow professional incorporation, depending on the province of residence, include doctors, dentists, veterinarians, accountants, and lawyers. It is important to note that the governing bodies of regulated professionals are generally unique to each province. Take, for example, doctors – there is a governing body for doctors in each province (provincial medical association). A doctor in Manitoba is

Copyright © 2019 The Institute for Advanced Financial Education.

accountable to the Manitoba governing body. Each governing professional body sets out its own rules on professional corporations. As much as a professional body imposes its own rules with respect to incorporation, the income tax rules associated with a professional corporation are the same as any other corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

Taxation of Partnerships

Each Canadian province and territory has its own Partnership Act, with the exception of Quebec, which defines a contract of partnership in its civil code. In simple terms, a partnership is an unincorporated form of business where all income and expenses are taxed in the hands of the individual partners, rather than the partnership itself, on a flow-through basis.

The Income Tax Act (ITA) does not define the concept of a partnership, although it is generally considered to be an ongoing business relationship entered into by two or more persons (including corporate entities) with a view to profit. Partnerships can be formed by individuals, corporations, or a combination of individuals and corporations.

Typical characteristics of a partnership are a longer-term association (as compared to a single joint venture) with a sharing of profits and losses and joint liability for business activities among the partners. Whether a business arrangement is a partnership is a question of fact, regardless of how the parties represent themselves. The two main types of partnerships are:

- **General partnerships;**
- **Limited partnerships**.

Opting to formally register a partnership with an agreement that sets out the rights and obligations of the partners will not automatically lead to the conclusion a partnership exists. In determining whether a partnership truly exists for business purposes, two important considerations are the type and the extent of a person's involvement in the business. Through case law that applies in the common law provinces, the Supreme Court of Canada affirmed three fundamental criteria must be evident in the relationship demonstrated between two or more persons. The interrelated criterion requires that the two parties must be:

- Carrying on business,
- In common,
- With a view to making a profit.

The concept of "carrying on business" is a question of fact and law. The ability to bind the partnership is a relevant consideration in determining if the partnership is indeed carrying on business. As to whether the business is

Copyright © 2019 The Institute for Advanced Financial Education.

being carried on "in common" will require an assessment of the facts of the relationship. Management of the partnership by one partner will not preclude the "in common" aspect. Contributions to the partnership such as financial support, know-how, and common undertakings will be considerations. The third element, "with a view to making a profit" will be assessed based on the intentions of the parties.

General Partnerships

By far, most partnership arrangements are general partnerships. In a general partnership, all of the partners (whether individuals or corporate entities) are referred to as general partners, and the following applies to all:

- They share, in some measure, in the profits and losses of the partnership;
- They are involved in the management of partnership operations;
- They are jointly and severally liable for the debts and obligations of the partnership; and,
- They can bind the partnership and all of the other partners.

Limited Partnerships

In a limited partnership, at least one partner (and often more) is a limited partner while at least one other is a general partner. Unlike general partners, a limited partner is more characteristic of an investor, for the following reasons:

- Limited partners are not involved in the day-to-day operations of the business of the partnership;
- Limited partners have no say in the management of the partnership;
- Limited partners are not exposed to the general liabilities of the partnership; and,
- Loss exposure of the limited partner is limited to his or her capital investment in the partnership.

Limited partnerships are most often used for investment and tax shelter ventures.

Copyright © 2019 The Institute for Advanced Financial Education.

Limited Liability Partnerships

A **limited liability partnership (LLP)** (permitted in some provinces) is a special type of general partnership, involving professionals such as lawyers and accountants. In a limited liability partnership, the liability of a general partner is restricted when liabilities arise as a result of the negligence of other partners or employees under their supervision.

Example

Michael and Caroline are accountants operating an office in Toronto as a partnership. Their business is registered in Ontario as a limited liability partnership. A client has alleged that Michael provided incorrect advice, resulting in a tax reassessment, plus interest and penalties. The client is now suing the partnership for $1,000,000 in damages as a result of its financial losses and loss of reputation.

If the claim is successful, the partnership, including assets and income, will be subject to seizure to settle the claim. Michael's personal assets and income would likewise be subject to seizure, because it was his purported negligence that resulted in the client's loss. However, Caroline would not be personally liable for the loss (beyond her capital investment in the partnership), and her personal assets cannot be seized to settle the claim because she was not personally involved with the client.

In all other aspects, the partners in a limited liability partnership are treated the same as general partners in a general partnership, with respect to the allocation of net income or losses and joint and several liability for partnership debts.

Copyright © 2019 The Institute for Advanced Financial Education.

Fiscal Period of a Partnership

A partnership must calculate its income or loss for each fiscal period. The fiscal period for a partnership that includes at least one individual must be the calendar year (January 1 to December 31 inclusive).

Taxable Income of Partnerships & Partners

The income of a partnership is calculated as though the partnership is an entity separate from its individual partners. Earnings, investment income, expenses, and capital and non-capital losses are taken into consideration at the partnership level in order to calculate the net income of the partnership.

A partnership is not taxed on its net income nor does it file an income tax return. Rather, it files an annual information return, allocating income pro rata to the partners according to the terms of the partnership agreement.

EXAMPLE

Last year, the Good Luck partnership (a group of painters) earned $420,000 in contract fees and $9,000 in interest on short-term investments. Additionally, the partnership had $189,000 in operating expenses, including rent, utilities, and salaries paid to support staff. Overall, the partnership had $240,000 of net income.

For tax purposes, the partnership will allocate its net income equally among its three partners, pursuant to the terms of their partnership agreement. As a consequence, each partner will report income for the year of $80,000 on his or her personal tax return.

Copyright © 2019 The Institute for Advanced Financial Education.

Flow-Through Taxation

Net income reported to partners from a partnership retains its identity when it is allocated to the partner for tax purposes. There is a flow-through of the characteristic of the income - operating income is taxed as income (or as a business loss), interest as interest, dividends as dividends (including the gross-up and tax credit), and so on.

EXAMPLE

Continuing the example of Good Luck partnership, the net income of $240,000 includes $9,000 of interest income. The allocation to each of the three partners will be as follows:

Type of Income	Income Per Partner	Background
Professional income	$77,000	$240,000 total partnership income less $9,000 of interest income divided by 3 partners
Interest income	$3,000	$9,000 of interest income dividend by three partners results in $3,000 for each partner

Allocation of Partnership Losses

Capital losses, terminal losses, and capital cost allowance are recognized and reconciled at the partnership level and allocated to the partners, pro rata, for the applicable fiscal period.

The partnership does not report to its members both its capital gains and losses on the disposition of partnership capital property; instead, it reconciles the two at the partnership level and reports only net capital gains or net capital losses.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Last year, the RGB partnership had a net operating profit of $230,000. It also disposed of two non-depreciable capital properties, one resulting in a capital gain of $38,000 and the other resulting in a capital loss of $93,000. The gains and losses were reconciled at the partnership level; such that the partners as a group were allocated income of $230,000 and allowable capital loss of $27,500, ($93,000 capital loss reduced by $38,000 capital gain equals $55,000 times the 50% inclusion rate results in a $27,500 allowable capital loss).

The ITA requires that Capital Cost Allowance (CCA) on any capital properties owned by the partnership be claimed at the partnership level. This tax treatment occurs because only the owner of a property may claim CCA. Similarly, on the disposition of depreciable capital property, any recapture of CCA or terminal loss is calculated at the partnership level and either increases or decreases the partnership income reported to the individual partners. There is a flow-through where the income retains its character.

EXAMPLE

Last year, the RGB partnership had a net operating profit of $230,000. The partnership also sold depreciable capital property for its FMV of $80,000. The property had an undepreciated capital cost (UCC) of $120,000, resulting in a terminal loss of $40,000. The operating profit and terminal loss were reconciled at the partnership level, such that the partners as a group were allocated net income of $190,000 ($230,000 operating profit less $40,000 terminal loss).

Copyright © 2019 The Institute for Advanced Financial Education.

Adjusted Cost Base

All partners have an Adjusted Cost Base (ACB) in their partnership interest. In general terms, the ACB represents the partner's net tax-paid investment. The ACB is the amount of money the partner can remove from the partnership on a tax-free basis. Conceptually, the ACB of the partnership interest is the original cost (investment), plus and minus adjustments for earnings, drawings, and other items.

Partnership Draw

Anytime a partner withdraws money from the partnership, it is treated as a draw, not income, and reduces the partner's ACB in her partnership interest. Earnings of the partnership are calculated at the partnership's fiscal year-end. Net income (or net loss) is allocated proportionately to each partner's share in the partnership and is then taxed in the hands of each partner personally. An allocation of earnings increases the partners' ACB while losses decrease their ACB.

EXAMPLE 1

In the earlier Good Luck partnership example, each partner is required to report $80,000 of income for the most recent tax year ($77,000 of professional income and $3,000 of interest income). This income must be reported by the partner, regardless of whether she chooses to withdraw any funds from the corporation. Upon reporting the $80,000 in the tax year, the partner will have a simultaneous increase to the ACB of her partnership interest to reflect that she has now paid tax on the $80,000 of income allocation.

If the partner withdraws $70,000 of funds from the partnership during the tax year, this full amount is applied as a reduction to her ACB.

The net effect of the $80,000 of new income, plus the $70,000 of withdrawals, means there will be an overall $10,000 increase to the ACB of her partnership interest.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE 2

Last month, Terri, a Canadian resident, joined an existing partnership made up of professional home renovators, all of whom are also Canadian residents. All of the other partners contributed $25,000 in money when the partnership was established.

Terri could not afford to match this capital contribution, but offered to transfer his truck to the partnership instead. The truck was originally purchased for $38,000 but was valued at $27,000 and had a UCC of $22,000, at the time of transfer. Terri did not want to report $5,000 of recapture of CCA on the transaction, so with the agreement of the existing partners he elected proceeds on the transfer of $22,000 (the UCC of the property). Consequently, the capital cost of the truck to the partnership is also $22,000. Terri's ACB for his partnership interest will be $22,000. There is no impact on the ACB of the other partners' interests. To achieve this tax-free transfer, Terri made an election under subsection 85(2) of the ITA (details of a transfer of this nature to a partnership are beyond the scope of this course).

Contribution of Property

The important outcome to be derived from this example is to show the contribution of property to an existing partnership by a new partner has no impact on the ACB of the partnership interests of the existing partners.

In effect, a partner's partnership interest is capital property and its ACB is equal to his or her investment interest in the partnership. In general, the ACB of a given partner's partnership interest essentially consists of the value of:

Copyright © 2019 The Institute for Advanced Financial Education.

Additions to ACB	• All property contributed to the partnership by the partner, including cash, based on the value of the property at the time of contribution. • The partner’s annual share of net partnership income.
Deductions from ACB	• The value of any partnership property distributed to the partner (based on the property’s FMV at the time of distribution). • All draws from the partnership by the partner.

EXAMPLE

Alicia contributed $50,000 in cash when she joined the XYZ partnership seven years ago. Since then, she has been allocated $720,000 of net income of the partnership (pursuant to a partnership agreement) and has taken cash draws totaling $650,000 over the same period. Additionally, last year the partnership transferred to Alicia an SUV that it no longer required. The SUV had an FMV of $16,000 at the time. Today, Alicia’s partnership interest has an ACB of $104,000 ($50,000 (starting balance) + 720,000 (income allocation) – $650,000 (cash draws) – $16,000 (draw in-kind) = $104,000).

As evident, a partner’s ACB will increase and decrease based on transactions throughout the fiscal period. Provided there is no actual disposition of the partnership interest, a negative ACB will not be taxed as a capital gain. At the time of an actual disposition (i.e. partner disposes of her interest in the partnership), any negative ACB is then added to any capital gain realized.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Burt disposes of his interest in Double P Partnership. He receives $200,000 for his interest at the same time that his ACB is negative $4,000. His taxable capital gain would be determined as follows.

Proceeds of disposition	$200,000
less: Selling costs	(4,000)
Net Sales Proceeds	196,000
add: Negative ACB	4,000
Capital gain (loss)	200,000
Taxable Capital Gain	$100,000

A partnership interest is capital property and it can be sold or can be deemed to have been disposed of. As with any capital property, a capital gain or loss will arise on the disposition (or deemed disposition) resulting in a capital gain or loss.

Note that the term "deemed" is used throughout the ITA to assert that an event has occurred for tax purposes only.

EXAMPLE

Wilson passed away last month and, at that time, was deemed to have disposed of his partnership interest in Wilson Thompson Law Firm for proceeds of $270,000 (the FMV of the interest at that time). The ACB of Wilson's partnership interest at the time of his passing was $195,000. Consequently, a capital gain of $75,000 was reported on Wilson's final income tax return ($270,000 – $195,000 = $75,000).

Copyright © 2019 The Institute for Advanced Financial Education.

Partnership Property

Partnership property is any property (including capital contributions) originally contributed to the partnership by the partners, and any property subsequently acquired by the partnership.

Establishing whether a given property is partnership property or is the personal property of the partners is a question of fact. The general rule is that the intent of the partners, usually as set out in the partnership agreement, will govern any issue of ownership.

EXAMPLE

Tom and Gerald formed a business partnership, contributing cash of $100,000 and $50,000, respectively. Their partnership agreement provides that Tom is entitled to receive two-thirds of the partnership's net profits and Gerald one-third (2:1 ratio).

In addition to the cash, Tom also made tools and equipment worth $25,000 available to the partnership, for which the partnership pays him an annual fee of $3,000, which is deducted from the partnership's annual gross income prior to the determination of net profits.

The ratio of 2:1 in the division of net partnership profits between Tom and Gerald is not affected by the transfer of the tools and equipment, so it is reasonable to assume that they were not a contribution of capital. The partnership does not own the tools and equipment; they remain the property of Tom and are leased by the partnership.

Withdrawal or Retirement of a Partner

For tax purposes, a partner withdrawing from a partnership (either at retirement or for any other reason) is referred to as retiring from the partnership. The income tax implications to a retiring partner vary depending on the circumstances of the partner's departure.

Copyright © 2019 The Institute for Advanced Financial Education.

Capital Interest

If the whole partnership interest is bought out at the partner's retirement, the transaction is treated like any other capital transaction and often results in the reporting of a capital gain or loss to the retiring partner.

EXAMPLE

Todd was a partner in a partnership, holding an interest with an ACB of $60,000 and an FMV of $100,000. He retired last year, and his partners paid him $100,000 for his partnership interest. As a result of the purchase, Todd reported a $40,000 capital gain for the year ($100,000 – $60,000 = $40,000).

If only a portion of the partner's partnership interest is bought out initially, there is no disposition for tax purposes until the entire partnership interest has been sold. The partner is said to own a residual interest in the partnership until the purchase is complete. Any payments made on account of the purchase are deducted from the ACB of the retiring partner's partnership interest, even to the point of creating a negative ACB. Only when the buyout is completed is a capital gain or loss reported to the selling partner.

EXAMPLE (CONT'D)

If Todd sells his partnership interest in installments, the income tax implications will be different from that of an outright sale. Assume, for example, he sells his interest for $25,000 a year for four years, representing a total of $100,000. The outcome would be:

- **Year 1**: No disposition for tax purposes. The $25,000 payment received by Todd reduces the ACB of his partnership interest from $60,000 to $35,000.
- **Year 2**: Again, no disposition for tax purposes. The $25,000 payment received by Todd reduces the ACB of his partnership interest from $35,000 to $10,000.
- **Year 3**: Again, no disposition for tax purposes. The $25,000 payment received by Todd reduces the ACB of his partnership interest from $10,000 to ($15,000).
- **Year 4**: When the final payment is made, there is a disposition for income tax purposes and Todd must report a capital gain of $40,000 (the $25,000 final payment plus the negative ACB of $15,000).

Copyright © 2019 The Institute for Advanced Financial Education.

Income Interest

A retiring partner can contract with the partnership to receive an allocation of income in the future (either income accrued as at the date of retirement or prospective income to be generated by the remaining partners). In this arrangement, the retiring partner has an income interest in the partnership even though her capital interest has been disposed of. Any income or loss allocated under such an agreement is treated as an income or loss of the retiring/retired partner and not of the partnership.

The following are features of this type of arrangement:

- The right to be allocated income may be in favour of the retiring partner or his or her spouse/common-law partner, estate (or heirs), assignee, or successor;
- A right to share in accrued or future income of the partnership is not considered a capital property;
- The recipient of the income is deemed to be a member of the partnership only for the purpose of allocating income or losses;
- Allocations of income or loss must be included in the recipient's income for the calendar year in which the partnership's fiscal year ends;
- At the death of the recipient, income to the date of death is included in the income of the owner for the year of death but may qualify as a right or thing.

EXAMPLE

Bev retired as a partner from a financial planning firm and was paid a lump sum of $500,000 as the purchase price of his partnership interest, which had an ACB of $200,000. In addition, the partners agreed to pay him 10 percent of the net partnership income (of about $1,000,000 annually) for the next five years to compensate him for the value his name brings to the partnership (known as the drawing value).

Bev must report a capital gain of $300,000 ($500,000 proceeds – $200,000 ACB = $300,000 capital gain) for the year that he retires and an additional $100,000 of partnership income for the next five years.

Copyright © 2019 The Institute for Advanced Financial Education.

Death of a Partner

Generally speaking, a partnership is dissolved by the death of a partner, and the fiscal year of the partnership is terminated at that date. The surviving partner(s) then has three options:

1. They can carry on the partnership with the deceased's estate, heirs, or a third-party purchaser of the deceased's partnership interest.
2. They can buy out the deceased's partnership interest and carry on the partnership.
3. They can cause the partnership to be wound-up.

Prior Agreement

If there is prior agreement among the partners, the partnership's year-end is not affected by the death of a partner. If the fiscal period ends with the death of a partner, the deceased partner's share of income for the year of death is included on her final tax return and is added to the ACB of the deceased partner's partnership interest (so as to avoid double taxation).

Fiscal Period

If the partnership's fiscal period does not end with the death of a partner, the deceased partner's allocation of partnership income from the end of the last fiscal period to the date of death is treated as a right or thing in the hands of the deceased and is again added to the ACB of the deceased's partnership interest. By virtue of subsection 70(2), the value of rights or things is included in the regular return of income for the year of death or may be included in a separate rights or things return if the deceased partner's legal representative so elects.

Copyright © 2019 The Institute for Advanced Financial Education.

Tax Treatment on Deemed Disposition

A deceased partner is deemed to have disposed of a partnership interest at the date of death for proceeds equal to its FMV at the time, with any capital gain or loss reported accordingly. In the case of a transfer of the deceased partner's partnership interest to a spouse or common-law partner (or spousal trust), there is no deemed disposition at FMV if the recipient is a member of the partnership or will become a member as a consequence of the transfer. In this case, the recipient inherits the partnership interest at the ACB of the deceased (a tax-deferred rollover). Similarly, the transfer of a residual interest in a partnership transfers to a spouse or common-law partner at the deceased's ACB.

EXAMPLE

Tony died on November 10 last year. At the time of his death, he owned an interest in the Two Lu partnership worth $39,000 and with an ACB of $20,000. Tony bequeathed his interest to his spouse Maxine, who was also a member of the partnership. Tony is deemed to have disposed of his interest in the partnership for proceeds of $20,000 (ACB of the interest) with no gain or loss to report. Maxine is deemed to acquire the interest with an ACB of $20,000.

If a deceased partner is entitled to any income or loss from the partnership incurred after the date of death, and the income or loss is to be allocated to the deceased's spouse, common-law partner, estate, or heirs, then the recipient has an income interest in the partnership, and any income or loss so allocated will be taxed in the hands of the recipient.

Copyright © 2019 The Institute for Advanced Financial Education.

Wind-Up of a Partnership

A partnership may be wound-up or dissolved by effect of law (i.e. retirement, death, or bankruptcy of a partner) or by mutual consent of the partners. However, the partnership is deemed to continue and the partners remain partners, until all partnership property has been distributed. Until then, each partner is deemed to have a residual interest in the right to receive partnership property, and the distribution of such property adjusts the ACB of partnership interests accordingly.

The partnership's fiscal period is deemed to end immediately on the wind-up of the partnership, at which point all income and losses for the current period are allocated. However, a new fiscal period begins immediately and ends the earlier of its usual end date (i.e. December 31) and the date on which all of the partnership property has been distributed. If a partner's partnership interest has a negative ACB at the end of a post wind-up fiscal period, the negative ACB is treated as a capital gain in the hands of the partner, and the ACB of the partnership interest is adjusted to nil.

If the partnership property is sold to third parties and cash is distributed pro rata to the partners, any capital gain or loss, the recapture of CCA or terminal loss is allocated to the partners accordingly.

Property distributed to the partners in settlement of their partnership interest is treated as having been disposed of for proceeds equal to its FMV and acquired by the recipient partners for a like amount.

EXAMPLE

On the wind-up of Jim and Bob's partnership, a house owned by the partnership was transferred to Jim at its FMV of $240,000. The partnership reported a gain or loss based on proceeds of $240,000, and Jim received the property with an ACB of $240,000. The ACB of Jim's partnership interest was reduced accordingly.

Copyright © 2019 The Institute for Advanced Financial Education.

Rolled to the Partners

Aside from being sold at the time of winding-up, partnership property may be rolled to the partners.

The property can be rolled to those partners who so elect and must be held by those partners in joint ownership. The election must be made for each property to be distributed this way, and the percentage allocation to each partner must be the same for all distributed properties (e.g. if Partner A receives a 40 percent interest in property X, she must receive a 40 percent interest in all other properties distributed to the partners for the rollover to apply).

A partner who receives rolled property must report a capital gain on the disposition of their partnership interest to the extent that the elected value of the rolled property plus any money received exceeds the ACB of the partner's partnership interest.

EXAMPLE

Upon dissolution of the MNO partnership, M received $50,000 in cash and a 33 percent interest in partnership property worth $240,000 (M's share would be $80,000). The ACB of the partnership's property at the time of the rollover was $180,000, so M's ACB on his share of the rolled property is $60,000 ($180,000 x 33 percent = $60,000). M's deemed proceeds of disposition would be the $50,000 of money plus the $60,000 of ACB of property for a total of $110,000. Assuming that the ACB of M's partnership interest at the time of winding-up was $110,000, he would not have to report a capital gain or loss on the distribution of his partnership interest.

Copyright © 2019 The Institute for Advanced Financial Education.

Rolled to a Sole Proprietor

If within three months of the dissolution of a Canadian partnership, a single member of the former partnership carries it on as a sole proprietor and continues to use property that belonged to the partnership, the property can be transferred from the partnership to the sole proprietor on a rollover basis.

Rolled to a New Partnership

If a partnership dissolves and distributes all of its property to the partners on a rollover basis, and the partners subsequently join, or form, a new partnership, the distributed property can be transferred to the new partnership on a rollover basis.

Rolled to a Corporation

Partnership property can be transferred to a corporation on a rollover basis on the winding-up of the partnership, under section 85 of the ITA.

Uses of Limited Partnerships

Limited partnerships are most commonly used to facilitate investment tax shelters because they permit the flow-through of income and losses to the limited partners while retaining the character of the income or losses. Further, limited partnerships allocate income and losses to those members who are partners at the end of the partnership's fiscal period regardless of whether those members were partners when the income or losses were incurred.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

In September last year, Mahmood joined the CanOil Exploration tax shelter partnership by buying units of the fund for $50,000. Early last year the partnership (fund) incurred significant Canadian exploration expenses, $30,000 of which could be allocated, pro rata, to the units of the fund that Mahmood had purchased. At year-end last year, Mahmood was allocated $30,000 in losses from the fund, which he could claim as a deduction against his other sources of income, even though he had not been an investor in the fund at the time the losses were incurred. The $30,000 of losses allocated to Mahmood will reduce the ACB of his interest in the fund from $50,000 to $20,000.

At-Risk Rules

The at-risk rules limit the amount of partnership losses an investor can claim against other income sources to the amount of capital the taxpayer has invested in the partnership at any given time.

EXAMPLE (CONT'D)

If the CanOil Exploration fund incurs more exploration expenses the following year and there are no other adjustments to the ACB of Mahmood's interest in the fund, he may not be able to take full advantage of the losses. For example, if an additional $30,000 of expenses is allocated to Mahmood, he can claim only $20,000 of these against other income, reducing the ACB of his interest in the fund from $20,000 to nil. The other $10,000 in deductible expenses can be carried forward, and claimed by Mahmood, if the ACB of his interest in the fund grows to a positive figure in the future.

Copyright © 2019 The Institute for Advanced Financial Education.

Taxation on Dispositions

If a partner in a limited partnership sells his or her interest in the partnership before the year's fiscal period-end allocation of income or losses, the result will be a capital gain or loss on the sale (or deemed disposition) of the interest. For example, if the fund had distributed (but not yet allocated for tax purposes) income from the fund before a disposition of an investor's interest, the distribution would decrease the investor's ACB. As such, it would increase the capital gain (or decreasing the capital loss) otherwise incurred at the time of disposition.

EXAMPLE

Early last year, Teal invested $20,000 in a tax shelter partnership. The fund distributed income mid-year, including $3,000 to Teal, which reduced the ACB of her fund units from $20,000 to $17,000. In early December last year, before the fund made its year-end allocation of income and losses, Teal disposed of her interest in the fund for proceeds of $21,000. Because Teal is not a member of the partnership on December 31 last year, she receives no allocation of income or losses from the fund. However, she must report a capital gain of $4,000 on the sale ($21,000 proceeds – $17,000 ACB).

Copyright © 2019 The Institute for Advanced Financial Education.

Definitions & Corporate Relationships

The concept of taxation is more than simply a series of rules and formulas. As a business advisor, it is important to understand key terminology in order to effectively utilize tax planning strategies that allow clients to achieve their objectives with predictable results. The interrelationship of various provisions throughout the ITA needs to be well understood in order to optimize the outcome and avoid negative tax consequences that can arise if used inappropriately.

This section looks at core definitions that are fundamental to the application of corporate taxation in a planning context. Understanding the definition of a Canadian-controlled private corporation and small business corporation is essential to the effective application of other provisions throughout the ITA. The concept of non-arm's length is explored and extends into the application of the terms related, associated, connected, and affiliated.

Canadian Corporation

A Canadian corporation is a corporation resident in Canada that was either incorporated in Canada or continuously resident in Canada from June 18, 1971.

Why is this important? Only a Canadian corporation can:

- Be a Canadian-Controlled Private Corporation (CCPC);
- Utilize the benefits of sections 85, 87 (amalgamation) and 88 (wind-up);
- Pay dividends that qualify for the dividend tax credit.

Copyright © 2019 The Institute for Advanced Financial Education.

Residence of a Corporation

Under common law principles, the residence of a corporation is determined by the location of its central management and control, traditionally understood to be the jurisdiction in which the majority of the corporation's directors meet to decide corporate policy. This means where central management and control is actually exercised. However, even if its directors meet outside of Canada, subsection 250(4) deems the corporation resident in Canada if:

- It was incorporated in Canada after April 26, 1965; or,
- It was incorporated in Canada before April 27, 1965, and, in any taxation year thereafter, it was resident in Canada under common law principles or carried on business in Canada.

Effectively, the incorporation of a company in Canada, under provincial or federal law after April 26, 1965, will cause a corporation to be deemed a resident of Canada. To become non-resident, the corporation would need to be deemed resident by another country as a result of the tax treaty tie-breaker rules.

Public Corporation

While the taxation of public corporations is not within the scope of this material, it is helpful to understand, in general terms, how the ITA defines a public corporation. A corporation resident in Canada is a public corporation when:

- A class of shares of the corporation is listed on a designated stock exchange in Canada; or,
- The corporation has met the conditions and elected to be a public corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

Private Corporation

A private corporation is defined in subsection 89(1) for Canadian tax purposes. In general terms, a corporation is considered a private corporation when it is:

- Resident in Canada;
- Not a public corporation; and,
- Not controlled by a:
    - Public corporation (other than a prescribed venture capital corporation); or,
    - Prescribed federal Crown Corporation.

Canadian-Controlled Private Corporation (CCPC)

Subsection 248(1) provides definitions that apply throughout the ITA. The definition of a **Canadian-Controlled Private Corporation (CCPC)** in subsection 248(1) provides that the meaning assigned in subsection 125(7) is to be used throughout the ITA. In simple terms, a CCPC is a private Canadian corporation that is not controlled, directly or indirectly, by non-residents. The wording focuses on ensuring that non-residents do not control the corporation.

If a corporation is privately owned (i.e. corporate shares are neither listed on a stock exchange nor offered freely to the public through stockbrokers on the over-the-counter market) and, if it is not owned by a public corporation and is owned 50 percent or more by Canadian residents, the corporation will qualify as a Canadian-controlled private corporation (CCPC). This distinction is particularly important because one of the qualifying conditions for the "Small Business Deduction" (SBD) requires the corporation to be a CCPC. The SBD, available under section 125 of the ITA, provides a corporation with the opportunity for preferred taxation and will be discussed in more detail in Module 2.

While it may seem obvious, it is important to understand that only a Canadian corporation can be a CCPC.

Copyright © 2019 The Institute for Advanced Financial Education.

Small Business Corporation (SBC)

In simple terms, the definition of a **Small Business Corporation (SBC)** as defined in subsection 248(1) is:

> A Canadian-controlled private corporation that uses all or substantially all of the fair market value of the assets principally in an active business carried on primarily in Canada by the particular corporation or a corporation related to it.

The verbiage sounds simple, but let's look at the meaning of the highlighted words.

- **Principally**: Generally, this is considered to be 50 percent or more.
- **Substantially all**: Generally, this is considered to be at least 90 percent. Keep in mind the 90 percent is not hardcoded in the ITA and is not a fixed number; rather, it is the generally accepted norm by the CRA. There is, however, case precedent that supports something moderately less than 90 percent depending on the specific circumstances. For certainty in tax planning, the 90 percent is considered an acceptable standard when encountering the term "substantially all."
- **Active business**: An active business is a business carried on by the taxpayer other than a specified investment business or a personal services business. A 2013 decision by the Federal Court of Appeal in Ollenberger v The Queen confirmed that to meet the definition of an "active business" (subsection 248(1)), a business does not have to be "active" as defined within the dictionary meaning of the term "active."

Based on an interpretation of the term "active business" as defined in subsection 248(1), the Federal Court of Appeal concluded that any business being carried on is an active business, except if it is a **Specified Investment Business (SIB)** or a **Personal Services Business (PSB)**. Effectively, there are two carve-outs:

- Businesses that derive income from property and, in doing so, employ fewer than five full-time people. This is considered a SIB as defined in subsection 125(2)); and,
- A personal service business (PSB as defined in subsection 125(7)).

In very simple terms, a personal service business is one where an individual provides services through a corporation but the services are truly that of an employee. The corporation is simply an intermediary and unnecessary to the

Copyright © 2019 The Institute for Advanced Financial Education.

provision of the services. The term “incorporated employee” is commonly used in the context of a personal services business.

A company that qualifies as a “small business corporation” (SBC) is entitled to special tax incentives otherwise not available. This includes:

- Tax rates that are more favourable than for regular corporations;
- Special incentives such as an “allowable business investment loss” that encourages investment in small business by reducing an investor’s potential loss should the business not succeed.

For an individual to qualify for the capital gains exemption, the shares of the corporation must qualify for Qualified Small Business Corporation (QSBC) status, which starts with being a small business corporation.

Control

The term “control” is utilized throughout the ITA and is an important consideration when interpreting a variety of provisions. In the ITA, the concept of control can be looked at from two perspectives – de jure or de facto control. In simple terms, **de jure control** is legal control (i.e. votes that provide the ability to elect the majority of the board of directors), whereas de facto control is actual control.

De facto control is defined in subsection 256(5.1), which addresses how the phrase “controlled, directly or indirectly in any manner whatever” is to be interpreted throughout the ITA. De facto control results in control in fact. Indicators of control in fact include the ability to control the business operations, ownership of a large debt owed by the corporation, and ownership of retractable shares. Section 256(5.11) was introduced to add clarity to the broad interpretation of the term control in fact. It states that control in fact “takes into consideration all factors that are relevant in the circumstances.”

Shotgun clauses and a right of first refusal are exceptions and do not result in de facto control.

Copyright © 2019 The Institute for Advanced Financial Education.

Relationships

Relationships can involve people, corporations, and trusts. Throughout the ITA, the term "person" is used regularly. However, it is not the simple dictionary meaning, but rather it is a defined term that includes an individual, a corporation, or a trust. Understanding relationships are essential because the application of many tax rules is often based on the relationship between the parties involved in the transaction, particularly for transactions that involve private corporations.

The ITA pays special attention to transactions that take place between parties who are considered not to be dealing at arm's length. Notice the terminology – "not to be dealing at arm's length." In other words, they are considered to be "non-arm's length." There are anti-avoidance rules throughout the ITA based on relationships, but there is also favorable tax treatment dependent on relationships.

The ITA specifically defines relationships, which could be viewed as concentric circles. The most encompassing circle is non-arm's length relationships.

Non-Arm's Length

The term non-arm's length is not directly defined within the ITA. Rather, it is defined indirectly through the definition of arm's length (subsection 251(1)). For example, related persons are deemed not to deal with each other at arm's length. In general terms, a taxpayer and a personal trust are deemed non-arm's length if the taxpayer, or any person not dealing at arm's length with the taxpayer, would be beneficially interested in the trust (with some exceptions). As well, persons not related to each other could be viewed as non-arm's length depending on the specific facts of the situation.

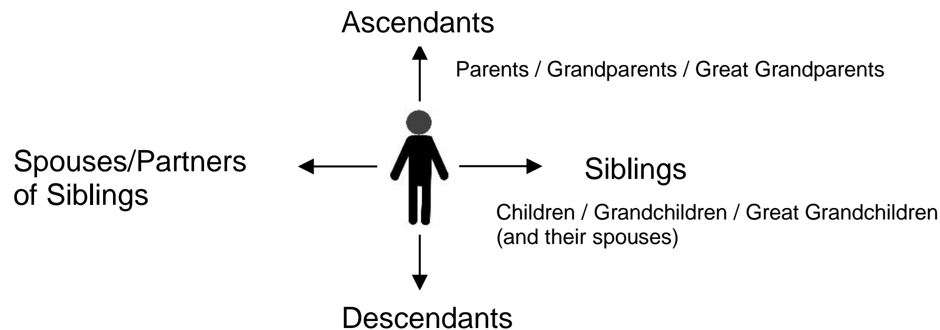
Copyright © 2019 The Institute for Advanced Financial Education.

Related

The term related is defined in subsection 251(2). Individuals are considered related when they are connected by:

- Blood relationship;
- Marriage or common-law partnership; or,
- Adoption.

It is important, however, to understand that the term "blood relationship" is not the normal dictionary definition of blood relationship. Instead, the term blood relationship is specifically defined in the ITA. The outcome is shown in the figure below. In general terms, an individual is related to his direct ascendants (i.e. parents, grandparents, and great-grandparents), direct descendants (i.e. children, grandchildren, and great-grandchildren), siblings (i.e. sisters, brothers and their spouses), spouse or common-law partner, and siblings of the individual's spouse or common-law partner.



Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Thirty-three year-old Jane is the daughter of Tom and Hilda. Jane is married to Sam, and they have a two-year-old son, Terry. Jane's only sibling is Micky who is married to Sarah. Micky and Sarah have one child, Shannon, age one.

Jane is related to:

- Her parents, Tom and Hilda (ascendants);
- Her husband, Sam (spouse);
- Her brother, Micky (sibling);
- Her son, Terry (descendant);
- Her sister-in-law, Sarah (sibling's spouse).

Jane is not related to:

- Her niece, Shannon (sibling's child).

As outlined above, individuals can be related to individuals but, in addition, corporations and individuals can be related, as can corporations and corporations. Without getting too complex, the following is an overview of when a person and a corporation can be related and when two corporations are related.

A corporation is related to:

1. A person who controls the corporation, if the corporation is controlled by one person;
2. A member of a related group that controls the corporation;
3. Any person related to a person described in 1 or 2 above.

Two corporations are related when:

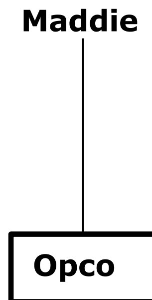
1. The same person or group of persons control the two corporations;
2. The two corporations are each controlled by a different person (A & B) but A & B are related to each other.

These are simple examples of when two corporations are related. Discussions of more complex relationships are beyond the scope of this material.

Copyright © 2019 The Institute for Advanced Financial Education.

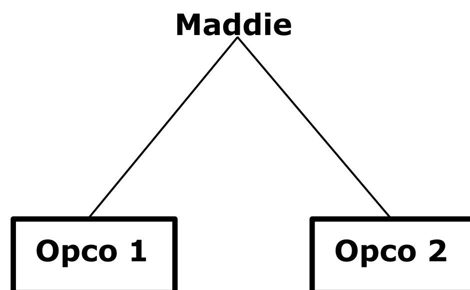
EXAMPLE 1

Maddie, the sole shareholder of Opco, controls Opco. This makes Maddie and Opco related.



EXAMPLE 2

Maddie is the sole shareholder of both Opco 1 and Opco 2. This makes Opco 1 and Opco 2 related because Maddie controls both corporations.



Copyright © 2019 The Institute for Advanced Financial Education.

Associated

The term "**associated**" refers to relationships at a corporate level. The basic rules for determining the circumstances under which corporations are associated are outlined in subsection 251(1). The primary test for determining association is one of control. Generally, corporations are considered associated if one corporation controls the other, or if the corporations are controlled, directly or indirectly, by one person or related persons.

The provision looks at the issue of common control, which can exist if there is direct or indirect influence. As discussed earlier, the concept of control goes beyond simply voting control; it also includes the concept of de facto control where indirect factors, such as the ability to influence, are considered when assessing who controls the corporation.

When corporations are considered associated, the ITA limits access to some tax incentives. The general purpose behind this approach is to avoid the use of multiple corporations to multiply access to special tax inducements. For example, the small business deduction (low tax rates on the first $500,000 of active business income) is shared between corporations that are considered associated.

Connected

The term "**connected**" is important because it allows corporate dividends to flow upstream, from one corporation to another, without taxation. The payment of tax-free inter-corporate dividends allows money to be moved upstream without incurring tax consequences (except if the paying corporation receives a dividend refund).

There are other circumstances where the term connected is used, but they are beyond the scope of this course.

Subsection 186(4) defines two corporations as connected when:

a. A corporation (particular corporation) controls another corporation (payer corporation).

b. A corporation (particular corporation) owns shares of another corporation (payer corporation) and the shares represent more than 10 percent of both votes and value of the payer corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

In simple terms, two corporations are connected when one corporation owns more than 10 percent of the control votes and value of the other corporation.

The term "control," for purposes of assessing if two corporations are connected, as outlined in (a) above, means:

- Corp A owns more than 50 percent of the issued share capital (with full voting rights) of Corp B.
- Person A owns more than 50 percent of the issued share capital (with full voting rights) of Corp B, and person A is non-arm's length to Corp A.
- Corp A and person A collectively own more than 50 percent of the issued share capital (with full voting rights) of Corp B, and person A and Corp A are non-arm's length.

Affiliated

The term "**affiliated**" was introduced in 1995 because the Department of Finance wanted to apply anti-avoidance rules to certain tax situations but felt the scope of "related" was too wide for some purposes. The term affiliated captures a narrower group of relationships than those under the term related.

Affiliated persons include those in the following relationships (among others):

- An individual and the individual's spouse or common-law partner;
- A corporation and a person (or the person's spouse or common-law partner) who controls the corporation;
- Two corporations, if each is controlled by the same person.

You will often see the concept of affiliated used to preclude individuals, trusts, and corporations from claiming losses when property is disposed of and reacquired by an affiliated person within certain periods of time.

- Superficial losses (section 54 definitions) can arise when an individual disposes of a capital property at a loss and re-acquires (or a person affiliated with the taxpayer reacquires) an identical property within the period that is 30 days before or 30 days after the taxpayer's disposition.

Copyright © 2019 The Institute for Advanced Financial Education.

- For trusts, partnerships, and corporations, the tax rules in section 40(3.4), referred to as the affiliated stop loss rules, can preclude the loss from being claimed under certain circumstances. Generally, when a corporation, trust, or partnership disposes of a property and a person affiliated with the taxpayer who disposed of the property acquires the property, or an identical property, within 30 days before or after the disposition, the affiliated stop loss rule precludes the taxpayer from claiming any loss that arises.

The term affiliated looks straightforward but can become complex when looking at the application in respect of trusts and partnerships, which is beyond the scope of this course.

Dividends

Dividends are amounts, declared by the board of directors of a corporation, paid to shareholders of the corporation. They represent a return on investment and are paid from current and retained earnings. They can take the form of cash, stocks, or other property. There is no requirement for a corporation to pay dividends; rather, they are paid at the discretion of the board of directors. Dividends are one of the few ways money can be distributed from a corporation.

Taxable Dividends

Taxable dividends, in Canada, can be either an:

- Eligible dividend; or,
- Non-eligible dividend.

Copyright © 2019 The Institute for Advanced Financial Education.

Eligible Dividend & GRIP Concept

An **eligible dividend** is a taxable dividend paid by a corporation out of after-tax income that has not benefited from any special tax preferences. For example, corporate income that was taxed at the regular (general) corporate tax rates and has not received any preferential tax treatment. A CCPC can pay eligible dividends, but only from its after-tax income that has not had any preferential tax treatment.

The "**General Rate Income Pool**" **(GRIP)** is used to track income taxed at the higher rate without any tax preferences. Income paid out of the GRIP account can be designated as an eligible dividend. While the addition to the GRIP account is calculated at the end of each taxation year, a corporation can pay eligible dividends throughout the course of the year provided that, at the end of the year, there is a sufficient balance in the GRIP account to cover any eligible dividends paid.

Corporations file schedules with their annual tax returns to show movement in the GRIP account as the CRA tracks GRIP activity. A corporation's GRIP balance, according to the CRA's records, is available online through the CRA's business window login.

An individual shareholder, who receives a taxable dividend designated as an eligible dividend will apply a dividend gross-up of 38 percent when calculating taxable income in respect of the dividend. This same individual will be eligible for a dividend tax credit. The corresponding federal dividend tax credit is 15.0198 percent of the taxable amount (2018 amount), while the corresponding provincial tax credit will differ depending on the individual's province of residence.

Copyright © 2019 The Institute for Advanced Financial Education.

Non-eligible Dividend & LRIP Concept

A **non-eligible dividend** is a dividend paid by a corporation out of income that has benefited from certain preferential tax rates or treatments. An example of this would be the portion of the corporation's income that was taxed at the low-rate applicable to the first $500,000 of active business income (i.e. the small business deduction).

The "**Low Rate Income Pool**" **(LRIP)** is used to track a corporation's after-tax income that has been taxed at a rate other than the high tax rate. Also included in the LRIP calculation is the corporation's net investment income.

Corporations file special schedules with their annual tax returns to show movement in the LRIP account, as the CRA tracks LRIP activity. A corporation's LRIP balance, according to the CRA's records, is available online through the CRA's business window login.

An individual shareholder, who receives a taxable dividend designated as a non-eligible dividend, will apply a dividend gross-up of 16 percent (2018 rate) when calculating taxable income in respect of the dividend. This same individual will be eligible for a dividend tax credit. The corresponding federal dividend tax credit is 10.0313 percent of the taxable amount (2018 rate), while the corresponding provincial tax credit will differ depending on the individual's province of residence.

Non-Taxable

A private company has the ability to elect a dividend as a capital dividend, which would be received tax-free by the shareholder. The company can make such an election to the extent there is a balance in its capital dividend account immediately before the time the dividend is declared. The capital dividend account is discussed in depth in module 2 of this course.

Copyright © 2019 The Institute for Advanced Financial Education.

Adjusted Cost Base

Adjusted Cost Base, commonly referred to by the acronym "ACB" is a defined term in the definitions of section 54 of the ITA. The section 54 definition is applicable throughout the ITA. In general terms, ACB refers to the dollar amount paid (in Canadian dollars) for the property.

Why is ACB important? It is used in calculating the capital gain or loss on a disposition of capital property. In certain circumstances, the ACB of a non-depreciable asset can be increased or decreased, as set out in section 53 and 54 of the ITA, depending on the transactions undertaken by the owner of the asset. For example, if a non-income producing piece of land has carrying costs that are not deductible, it may be possible to have these expenses added to the ACB of the property. Some forms of government assistance can reduce a property's ACB.

Cost is not defined for income tax purposes. The usual starting place for determining the cost of non- depreciable capital property is the cost for accounting purposes: the laid-down cost (i.e. invoice, relevant provincial sales tax, customs tax, etc.). From this amount, section 53 adjustments are applied to arrive at the definition as defined in section 54. Section 52 adjustments may also apply.

Paid-Up Capital

Paid-Up Capital, commonly referred to by the acronym "PUC" is an important tax attribute of corporate shares. In simple terms, PUC is the amount that shareholders pay direct to the company when they subscribe to shares issued by the company from its treasury.

When shareholders buy shares from another shareholder, the transaction is between the shareholders and does not impact the firm's PUC or any other financial aspect of the company.

PUC represents tax-paid money. A corporation can return a shareholder's PUC on a tax-free basis. If the shareholder has a large amount of PUC, this could be a tax-free source of cash flow from the company.

Copyright © 2019 The Institute for Advanced Financial Education.

PUC is calculated at the corporate level. The formula to calculate a corporation's total paid-up capital is simply:

$$\frac{\textbf{Sum of amounts paid for share subscriptions for class of shares}}{\textbf{Total number of issued and outstanding shares across all classes}}$$

As noted earlier, when a person buys shares from an existing shareholder, the PUC of the shares, or the firm as a whole, does not change. The new shareholder's ACB is equal to the amount the new person pays for the shares. PUC is not affected and remains the same regardless of the shareholder-to-shareholder transaction. Why? The transaction is between shareholders and does not involve the firm (other than to update the share register, which has no financial implication).

EXAMPLE

Doug subscribes to 100 common shares of DEF Inc., paying $1 for each. The total paid-up capital for all common shares is $100 (100 shares x $1 per share). He owns 100 percent of the issued and outstanding shares.

After five years of operations, Doug invites his brother, Daniel, to become a DEF shareholder. At that time, the company is valued at $100,000. The current FMV of DEF is $1,000 per share ($100,000 FMV ÷ 100 shares currently owned by Doug). The objective is for Daniel to own about 40 percent of DEF, so he subscribes to 67 common shares paying $67,000 to DEF (this gives Daniel 67 of 167 issued shares or 40.1%).

The company is now worth $167,000, made up of the current FMV of $100,000 and Daniel's subscription proceeds of $67,000. At this time, the total PUC is $67,100 being made up of Doug's subscription of $100 and Daniel's subscription of $67,000. The PUC per share would be $401.80 ($67,100 divided by 167 outstanding shares). Daniel's shares would have an ACB of $67,000 and a PUC of $26,920.

Another five years pass. Doug invites, David, his second brother, to join DEF as a shareholder. DEF is now valued at $334,000 or $2,000 per share. The objective is to allow David to own about 40 percent of the company, so he buys 67 common shares from Doug, paying him $134,000. At this point, Doug owns

Copyright © 2019 The Institute for Advanced Financial Education.

33 shares, Daniel owns 67 shares, and David 67 shares, for a total of 167 issued shares.

David's adjusted cost base is $134,000 and his paid-up capital is $26,920 (67 shares times $401.80 PUC per share).

	Beginning	Year 5	Year 10
Doug's subscription	100		
Daniel's subscription		67,000	
David's purchase from Doug			No impact on PUC
TOTAL PUC	**$100**	**$67,100**	**$67,100**
# of outstanding shares	100	167	167
PUC per share	$1	$401.80	$401.80

Copyright © 2019 The Institute for Advanced Financial Education.

Summary

After completing this module you should be able to:

- Analyze the different types of entities through which a business may be carried on;
- Propose a particular structure to address a client's specific objectives;
- Apply and synthesize legal and business concepts associated with a corporation as well as a partnership;
- Explain how taxation will impact individual members of a partnership;
- Explain the key terms and relationships used extensively in the application of corporate taxation.

Copyright © 2019 The Institute for Advanced Financial Education.

Module 2: Tax Planning for Private Corporations & Their Shareholders

Learning Objectives

Upon completion of this module, you should be able to:

- Apply and evaluate the general tax principles of corporate taxation and the components of corporate tax rates and their interrelationships;
- Apply and integrate the calculation, payment, receipt and penalties associated with the capital dividend account in client-specific situations;
- Apply and synthesize the tax consequences in respect of QSBC shares and the application of the capital gains exemption;
- Apply and synthesize the tax implications arising from the incidence of a shareholder benefit, shareholder as an employee, loans to shareholders, and the analysis of shareholder remuneration.

Copyright © 2019 The Institute for Advanced Financial Education.

Corporate Taxation

In some ways, corporations (both public and private) are taxed in the same ways as individuals; taxable income is determined, and the resulting tax liability is levied. However, corporations are subject to significantly different tax treatment, including different schedules of federal and provincial tax rates and the tax treatment of certain types of income. Further, private and public corporations are treated differently with respect to tax rates and the tax treatment of dividends, capital gains, and certain capital receipts.

This section is designed to address the tax treatment of Canadian-Controlled Private Corporations (CCPCs). The corporate tax structure is discussed, along with planning issues and the income tax effects of various planning strategies involving shareholders and private corporations.

Taxation of Corporations

Generally speaking, corporations resident in Canada are taxed on their worldwide income from all sources. Conceptually, corporations calculate their taxable income similarly to individuals but segment their taxable income into types of income such as active, manufacturing, dividend, and passive because each category is subject to a unique tax rate.

Taxation Year – Fiscal Period

The taxation year-end of a corporation is defined to be the corporation's fiscal period, which, in turn, is defined as the period, not exceeding 53 weeks, for which the accounts of the taxpayer are ordinarily made up. The 53-week limit accommodates a corporation in which the fiscal period ends, for example, on the last Friday of October each year. Such a corporation would have an October 26 year-end in 2018 and an October 25 year-end in 2019.

The first fiscal period of a corporation is generally selected arbitrarily and may be shorter than one year. Subsequent fiscal periods usually run for 12 months. Once established, the fiscal period cannot generally be changed

Copyright © 2019 The Institute for Advanced Financial Education.

without the Canada Revenue Agency's (CRA) written consent.

A corporation that is a member of a partnership carrying on the professional practice of an accountant, a dentist, a lawyer, a medical doctor, a veterinarian, or a chiropractor is required to report its income on a calendar-year basis (December 31 year-end).

Types of Income

Different types of income received by a corporation can be subject to different tax treatment, which directly impacts the effective tax rate of the corporation. The term active business income is important, as it provides access to certain tax benefits. Conceptually, active business income is the type of income derived through expelling energy (i.e., employees providing a service or the manufacturing of a product).

Passive income is generally the type of income that can be earned by the deployment of capital and does not usually require the energy of an employee. Passive income includes interest and dividend income as well as capital gains. Rental income is generally considered passive income, except when there are more than five full-time employees.

Active Business Income

The **active business income (ABI)** of a corporation is determined under the rules that apply to all taxpayers. Generally speaking, a corporation must calculate its net and taxable income in the same manner as an individual taxpayer taking into account gross revenues and deductible business expenses.

Copyright © 2019 The Institute for Advanced Financial Education.

Interest Income

The interest income of a corporation is determined under the rules that apply to all taxpayers. For public companies, interest income is taxed with its general revenues. For private companies, interest income is grouped with other passive types of income and is subject to unique tax rates.

Capital Gains/Losses of a Corporation

Where a corporation realizes capital gains or losses, half of the capital gain is taxable and half of the capital loss is deductible (the same as for individuals). Where allowable capital losses for a year exceed taxable capital gains, the net capital loss can be carried over to another taxation year and claimed against taxable capital gains arising in those years.

The capital gains exemption is only available to individuals; it is not available to corporations.

For a public corporation, the non-taxable portion of the capital gain or loss falls into or is applied against general surplus, which can be distributed to shareholders only in the form of taxable dividends. For a private corporation, the non-taxable portion of the capital gain or loss is included in a notional tax account called the Capital Dividend Account (CDA), from which any positive balance can be distributed tax-free in the form of capital dividends.

EXAMPLE

Happy Inc., a corporation that services widgets, sells a corporate asset for proceeds of $5,000. The tax cost (ACB) and accounting cost of this asset was $2,000. Happy Inc. would recognize a taxable capital gain of $1,500 (50% x ($5,000 – $2,000)). For accounting purposes, the corporation will add $3,000 to its retained earnings, equal to the proceeds minus the cost of the asset ($5,000 – $2,000).

Copyright © 2019 The Institute for Advanced Financial Education.

For a private corporation, the same $3,000 would become part of retained earnings, which could support a dividend of $3,000. However, $1,500 (amount equal to the non-taxable portion of the capital gain) could be elected as a capital dividend and paid tax-free by the shareholder.

For public corporations, $1,500 of the $3,000 of retained earnings represents the non-taxable portion of a capital gain. The full $3,000 would be a taxable dividend in the hands of shareholders when the amount is paid out by a public corporation.

Dividend Income

Dividends received by a corporation are included in determining its income (without applying the dividend gross-up, which applies only to individuals). The recipient corporation can then deduct the following from taxable income:

- Dividends received from taxable Canadian corporations;
- Dividends received from connected corporations resident in Canada;
- Dividends received from certain non-resident corporations.

The effect of this is that generally no Part I tax is payable by a CCPC on dividends received when the dividend is received from a connected corporation and the payor corporation does not receive a refund of refundable tax because of the dividend payment.

Part IV Tax

Private corporations may, however, be subject to a special Part IV tax on dividends received. Part IV tax is 38.33 percent and is levied on portfolio dividends (i.e., dividends received from public company shares or shares of a non-connected corporation) received and dividends received from connected corporations to the extent the paying corporation received a refund from its Refundable Dividend Tax On-Hand (RDTOH) account. Part IV tax is designed to prevent the deferral of tax on portfolio income through the use of privately held corporations. By applying a tax (38.33 percent) to portfolio dividends and making it refundable on the payment of taxable dividends, it removes the incentive to use corporations to hold shares for the

Copyright © 2019 The Institute for Advanced Financial Education.

benefit of deferring income.

There is a primary exception where no Part IV tax is payable. This occurs when dividends are paid between connected corporations. The definition of connected corporations was discussed in Module 1.

To recap, two corporations are connected when one corporation owns more than 10 percent of the control votes and value of the other corporation.

EXAMPLE

ABC Inc. received $12,000 in dividends from various public companies. The $12,000 would not be subject to Part I tax, but would instead be taxed under Part IV at the rate of 38.33 percent (38.33 percent x $12,000). This same amount is credited to the receiving corporation's RDTOH account, which is discussed later in this section.

EXAMPLE

XYZ Inc. received $12,000 in dividends from its wholly owned subsidiary. The subsidiary paid the $12,000 dividend from its after-tax active income. The $12,000 would not be subject to Part I tax and would fall within the exception to Part IV tax.

EXAMPLE

JKL Inc. received $12,000 in dividends from its wholly owned subsidiary. The subsidiary paid the $12,000 dividend from its after-tax passive income, which entitled it to a $4,000 refund of its refundable dividend tax on-hand. JKL would be liable for Part IV tax of 38.33 percent on the dividend received from its wholly owned subsidiary up to the amount of the refund received by the subsidiary. JKL would also have a credit in its RDTOH account, which is discussed later in this section.

Copyright © 2019 The Institute for Advanced Financial Education.

Federal Tax Rates

Unlike individuals who pay tax on a graduated rate basis, corporations are initially subject to one flat rate of tax on their full taxable income. The rate is currently 38 percent, but this is a nominal rate to which adjustments are applied.

Federal Tax Abatement

Both the federal and provincial governments collect corporate tax. In order to permit the provinces to impose their corporate tax, the federal government provides a federal tax abatement of 10 percent of taxable income earned in the year in a province. This abatement reduces the general federal tax rate on corporate income from Canadian sources from 38 percent to 28 percent. The amount of taxable income earned in the year in a province is determined under the ITA regulations, which apportion the corporation's taxable income from Canadian sources amongst the provinces according to a complex formula.

General Rate Reduction

A general tax reduction of 13 percent is available on qualifying income, which is defined as taxable income that is subject to a top federal rate. This means that the reduction does not apply to income that is subject to preferential tax treatment such as the small business deduction, manufacturing and processing deduction, and investment income that is subject to the refundable tax.

Copyright © 2019 The Institute for Advanced Financial Education.

Small Business Deduction

A CCPC can claim the Small Business Deduction (SBD), which reduces the federal rate applicable to the first $500,000 of active business income to a net tax rate of 9 percent (2019 calendar year pro-rated for the corporation's fiscal year).

An eligible corporation calculates its tax liability and then is entitled to a deduction of 19 percent of up to $500,000 (referred to as the business limit) of its active business income, resulting in a net 9 percent rate (2019).

EXAMPLE

MN Inc. earned $200,000 of taxable active business income during 2019. This was the only income earned that year.

MN Inc. is entitled to a small business deduction from its income tax liability, resulting in a net federal tax rate of 9 percent on the $200,000, or $18,000.

Rules that impact the available business limit will be discussed in a subsequent section.

Additional Refundable Tax (ART)

One of the goals of good tax policy is the integration of the tax rates applicable to individuals and corporations. The "Additional Refundable Tax" (ART) is one of the key elements in integration. The federal government levies an additional 10.67 percent tax (often referred to as ART) on the passive income earned by a CCPC. This additional tax is refundable when the corporation pays a taxable dividend to its shareholder.

The purpose of ART is to discourage the retention of passive assets within a corporation for long periods of time. By applying an extra 10.67 percent tax on passive income, that is refundable when taxable dividends are eventually paid by the corporation, the government is using ART as an incentive to discourage long term accumulation of assets within a corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

Summary

The following chart shows how the 2019 federal tax rate is calculated for corporations.

Corporate Federal Tax Rate Calculation			
	Active Business Income Above $500,000 (I)	Active Business Income Below $500,000 (II)	Passive Income (III)
a. Basic federal rate (starting place)	38%	38%	38%
b. Federal tax abatement (reduction for provincial residency)	(10%)	(10%)	(10%)
c. General rate reduction (if no other tax preferences)	(13%)		
d. Small business deduction (for qualifying corporations)		(19%)	
e. Additional refundable tax (charged on passive income earned by an SBC)			10.67%
f. Net federal tax rate	15%	9%	38.67%

The federal tax rate is generally applicable to a calendar year. A corporation with a fiscal year that straddles two calendar years must prorate their income based on the number of days in each calendar year.

Copyright © 2019 The Institute for Advanced Financial Education.

Interaction of Passive Income and the Small Business Deduction[1]

Recall that the small business deduction results in a 9 percent federal tax rate on active business income up to the $500,000 of active business income for qualifying CCPCs. This $500,000 is referred to as the small business limit.

Availability of this preferential tax rate is affected in the following two situations:

1. *Taxable capital* - Associated corporation share the small business limit. When total taxable capital employed in Canada by the CCPC and any associated corporations is between $10 million and $15 million, there is a reduction applied and the small business deduction is fully eliminated (no longer available) at $15 million of total taxable capital.
2. *AAII measure*[2] - The second scenario that affects the availability of the small business deduction involves corporations with substantial investment income. For corporate taxation years beginning after 2018, CCPCs (and their associated corporations) are subject to a reduced business limit when their investment income is between $50,000 and $150,000. The result is that a company's small business limit is reduced by $5 for every $1 of adjusted aggregate investment income (AAII) in excess of $50,000. The full $500,000 small business limit is completely eroded when the company's AAII reaches $150,000.

The business limit reduction arising under the AAII measure (described in (2) above) is designed to operate alongside the business limit reduction that applies with respect to taxable capital (described in (1) above). The reduction to a corporation's business limit is the greater of the AAII measure and the reduction based on taxable capital.

[1] Adapted from COMMENT, May/June 2018, James Kraft & Deborah Kraft
[2] This measure is new at the time of writing and the provinces have not yet weighed in on whether they plan to mirror this federal change for provincial tax purposes. The Ontario government has indicated it will not impose the AAII measure as it relates to adjustments to the small business deduction.

Copyright © 2019 The Institute for Advanced Financial Education.

What impacts the AAII calculation?

The following provides a general overview of items included in the calculation of AAII for the purposes of calculating the small business limit available to a CCPC:

- Taxable capital gains in excess of allowable capital losses
- Income from property (i.e., interest, dividends, rental, lease, royalties, etc.)
- Gains from the disposition of life insurance policies

Below are examples of items excluded from the calculation:

- Taxable capital gains realized on the sale of active business assets
- Allowable capital loss carry-forwards
- Passive income incidental to the active business
- Dividends from connected companies

As noted, the business limit is a shared amount across all associated corporations, which means that AAII is calculated taking into consideration the AAII of the group of associated companies. As such, the AAII of a holding company will be used in the operating company's calculation.

Corporations that are directly affected by the adjusted business limit are those that own an active business AND are accumulating an investment portfolio in the operating company or an associated company.

While initial estimates by the federal government suggest that only about three percent of CCPCs claiming the small business deduction will be affected by the AAII calculation, all CCPCs should keep this measure in mind when accumulating passive assets. For example, professionals (e.g., doctors, accountants, lawyers, etc.) have traditionally used corporations as a means to accumulate passive assets as an integral element of their financial plans.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Assume that a corporation that earns $10,000 of passive income in excess of the new $50,000 threshold.

1) Passive income is taxed at 50.17% (combined federal and provincial assumed rate), so $5,017 of tax is due on the $10,000 of passive income in excess of the $50,000 threshold.
2) The company will lose $50,000 of its small business limit ($5 for every $1 of passive income in excess of $50,000), leaving a business limit of $450,000.
3) The business limit is worth about 13% (assumes provincial 2018 rate calculated as the difference between 26.5% top rate and 13.5% tax rate on the first $500,000 of active business income).
4) The outcome of (2) and (3) above is a loss of $6,500 in tax benefits to the corporation (13% of $50,000).

In the example above, the corporation earned $10,000 of passive income in excess of the new $50,000 threshold. The tax cost of earning the extra $10,000 of passive income is the loss of $50,000 of small business limit ($5 for each $1 of excess income) and the higher tax amount on the $50,000 of lost business limit.

In this example, the corporation's income tax liability increases by $6,500 compared with the scenario where the corporation’s AAII is less than $50,000, so there is no impact on the $500,000 business limit. Note, however, because the corporation will pay a higher corporate tax on $50,000 of active business income (recall the small business limit was reduced from $500,000 to $450,000), the dividend associated with the $50,000 of income can be treated as an eligible dividend. An eligible dividend is subject to a lower rate of tax than a non-eligible dividend. The outcome is that the shareholder will experience a lower tax liability when receiving this dividend.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Do-It Inc. is a CCPC resident in a province that has a 12 percent provincial tax rate. In its current fiscal period, Do-It earned $100,000 of interest income on its bond portfolio. Do-It's corporate income tax liability with respect to the interest income would be $50,667, which is derived as 38.67 percent federally (Column III, Row f in Corporate Tax Rate chart shown earlier) and 12 percent provincially.

Of the $50,667 of tax liability, $30,667 is refundable when Do-It pays a taxable dividend to its shareholder. The $30,667 of refundable taxes would be reflected in Do-It Inc's non-eligible refundable dividend tax on hand account (NERDTOH). In order to recover the full amount of refundable taxes, Do-It will have to pay an $80,000 dividend to its shareholder (38.33 percent x $80,000 = $30,667). Do-It's net taxes payable on the bond interest is 20 percent (50.67 – 30.67 = 20), which leaves Do-It $80,000 after-tax to fund a dividend to its shareholder.

The dividend received by the Do-It shareholder would be a non-eligible dividend.

Dividends

There are two types of taxable dividends: eligible and non-eligible dividends.

Eligible dividends are:

- dividends paid by public companies; and,
- dividends paid by private companies where the dividend arises from income taxed at regular rates (income did not benefit from any tax preferences such as the small business deduction or part IV refundable tax).

Ineligible dividends are:

- dividends paid by private companies where the dividend arises from income that received some type of special tax preference (i.e., small business deduction).

Copyright © 2019 The Institute for Advanced Financial Education.

Payment of Taxable Dividends from Corporations

Corporations must track and allocate their income into two different pools: GRIP (General Rate Income Pool) and LRIP (Low Rate Income Pool)

The **GRIP** pool includes income taxed at high corporate rates. In a CCPC, this would include:

- Active business income not eligible for the small business deduction;
- Eligible dividends received from the GRIP of another corporation; and,
- Any amounts that did not receive preferred tax rates.

Dividends paid out of GRIP are referred to as eligible dividends. An individual shareholder who receives a GRIP dividend would be subject to a gross-up of 38 percent on the taxable dividend.

The **LRIP** pool includes income taxed at low corporate rates or income that has been subject to some level of preferential tax treatment. In a CCPC, this would include:

- Active business income that was taxed at a low tax rate because of its eligibility for the small business deduction; and,
- Aggregate investment income (AII) because it was eligible for tax relief as part of the NERDTOH account.

Dividends paid out of LRIP are referred to as non-eligible dividends. An individual shareholder who receives a LRIP dividend would be subject to a gross-up of 17%.

Aggregate Investment Income

In general terms, Aggregate Investment Income (AII) includes income from property (such as interest, royalties, rents, and dividends) plus net taxable capital gains less adjustments and is taxed at the top corporate rate (28 percent federal + 11.5 percent assumed provincial =39.5 percent) plus 10 2/3 percent (ART).

Copyright © 2019 The Institute for Advanced Financial Education.

Refundable Dividend Tax On Hand

For taxation years that begin after 2018, a CCPC maintains two types of notional accounts associated with the concept of refundable tax - eligible refundable dividend tax on hand (ERDTOH) and non-eligible refundable dividend tax on hand (NERDTOH).

The following is a general discussion to help provide background as to what is included in each of these two notional accounts.

The ERDTOH account includes:

- Any Part IV tax the corporation paid on eligible dividends received from non-connected corporations; and,
- Any Part IV tax paid on taxable dividends received from connected corporations (if the payor corporation received an ERDTOH dividend refund).

The NERDTOH account includes:

- The refundable portion of Part I income tax paid on AII; and,
- Any Part IV tax paid that was not included in the ERDTOH account.

When corporations pay taxable dividends, the corporation is eligible for a dividend refund. In general terms, a private corporation's dividend refund for a year will be equal to the total of the following three amounts:

- **A:** the lesser of
    - 38 1/3% of all eligible dividends paid in the year, and
    - the ERDTOH balance at the end of the year;
- **B:** the lesser of
    - 38 1/3% of all non-eligible dividends paid in the year, and
    - the NERDTOH balance at the end of the year; and
- **C:** either of the following
    - if 38 1/3% of the total of all non-eligible dividends paid in the year exceeds the NERDTOH balance at the end of the year, the lesser of:
        - the amount of the excess, and
        - the amount by which the ERDTOH balance at the end of the year exceeds A above, if any, determined for the year
    - in any other case, nil.

Copyright © 2019 The Institute for Advanced Financial Education.

In simple terms, the computation outlined here effectively requires the corporation to obtain a refund from its NERDTOH balance before a refund from its ERDTOH balance can be paid, when it pays a non-eligible dividend.

A private corporation cannot access its NERDTOH account as a means by which to obtain a dividend refund when an eligible dividend is paid (the logic being that the income was not subject to the higher-level refundable tax). But if the NERDTOH balance is nil, the corporation can access the ERDTOH balance when non-eligible dividends are paid.

EXAMPLE

Char Inc.'s annual tax return included the following information in respect of its refundable dividend tax on hand.

Non-Eligible Refundable Dividend Tax On Hand	
Refundable dividend tax on hand at the end of the previous tax year	$25,000
Deduct: Dividend refund for the previous tax year	($10,000)
Subtotal	$15,000
Refundable portion of Part I tax	$10,000
Total Part IV tax payable	$15,000
Refundable dividend tax on hand at the end of the tax year	$40,000
Dividend Refund	
a. 38.33% of taxable dividends paid (38.33% of $180,000)	$69,000
b. Refundable dividend tax on hand at the end of the tax year	$40,000
Lesser of (a) and (b):	$40,000

Char began the year with a $15,000 balance in its RDTOH account and paid $10,000 of refundable Part I taxes and $15,000 in Part IV taxes. While Char paid a $180,000 taxable dividend, which could trigger $69,000 of refundable, the refund is limited to the balance in the account, $40,000.

Copyright © 2019 The Institute for Advanced Financial Education.

Provincial Corporate Taxes

The provinces impose their own corporate tax rates on the portion of corporate taxable income earned in their jurisdiction. All provinces, other than Alberta and Québec, have an arrangement whereby the federal government administers and collects the provincial corporate income tax. Alberta and Québec administer and collect their own corporate taxes and a separate provincial corporate tax return must be filed in addition to the federal return. In all other provinces, one combined provincial and federal tax return is filed.

Allocation of Taxable Income

A corporation allocates its taxable income earned in a province based on the proportion of gross revenues earned through a permanent establishment in a province and the proportion of salaries and wages paid in a province. As such, there is a specific formula to determine the taxable income allocated to each province. This also means that gross sales earned without a permanent establishment in the province will not create an allocation to that province.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Topco Inc., whose headquarters are located in PEI, has permanent establishments in each of Alberta and Ontario. Topco sells to every part of Canada, and the offices in Ontario and Alberta service the nearby provinces.

Topco's allocation information is as follows:

	Gross Sales	Salaries/Wages
PEI	$1,000,000	$600,000
Ontario	$5,000,000	$200,000
Alberta	$4,000,000	$200,000

	Gross Sales	Salaries/Wages	Average
PEI	10%	60%	35%
Ontario	50%	20%	35%
Alberta	40%	20%	30%
TOTAL	100%	100%	100%

Topco would allocate its taxable income as 35, 35, and 30 percent in the provinces of PEI, Ontario, and Alberta, respectively.

Provincial Tax Rates

The 2018 effective corporate tax rates for each province are shown on the following chart. The SBD rate reflects the rate applicable to active business income of a small business corporation. The rate is based on the federal small business deduction ($500,000) or on other limits the provinces may impose. The high general rate is applied against all income that does not qualify for the small business deduction.

Copyright © 2019 The Institute for Advanced Financial Education.

2018 Combined Effective Federal & Provincial Tax Rates by Province		
Province	Tax Rate on ABI less than SBD limit*	Tax Rate on ABI in excess of the SBD limit
Newfoundland/Labrador	13%	30%
Nova Scotia	13%	31%
Prince Edward Island	14%	31%
New Brunswick	12.5%	29%
Quebec	14%	26.7%
Ontario	13.5%	25% / 26.5%**
Manitoba*	10%*	27%
Saskatchewan*	12%*	25% / 27%**
Alberta	12%	27%
British Columbia	12%	27%
Yukon	11.5% / 12%**	17.5% / 27%**
Northwest Territories	14%	26.5%
Nunavut	14%	27%

Notes:

The term ABI refers to active business income.

* The provinces of Saskatchewan and Manitoba utilize a small business limit of less than $500,000. As such, the rates listed apply to the applicable provincial small business limit.

** Ontario, Saskatchewan and Yukon apply a lower rate for manufacturing and processing activities over the small business limit.

*** Yukon applies a lower rate for manufacturing and processing activities up to the small business limit.

Copyright © 2019 The Institute for Advanced Financial Education.

Filing of Tax Returns

Every corporation must file a corporate income tax return (T2) within six months of its taxation year-end, even if there is no tax payable for the taxation year. For example, if a corporation's fiscal year ends on April 30, the firm's tax return will be due on October 30. A corporation's tax return must be filed on time; otherwise, the corporation may be subject to penalties. Should a corporation be eligible for a refund of income taxes, the relevant return must be filed no later than three years after the relevant year-end.

Tax Instalments

A corporation must pay its tax in monthly instalments, except where tax payable for the year, or for either the immediately preceding year or current year, is not more than $3,000. For this purpose, tax is the total of the corporation's Parts I, VI, VI.I and XIII.1 taxes. The amount payable each month can be calculated using one of three methods (the taxpayer can use whichever method is best for the corporation). Outlined briefly, these three methods are:

1. One-twelfth of the estimated tax liability for the current year.
2. One-twelfth of the actual taxes payable in the immediately preceding taxation year.
3. For the first two months of the current year, one-twelfth of the actual taxes payable in the second immediately preceding year; and, for the last 10 months of the current year, one-tenth of the immediately preceding year's liability, less any amounts paid in the first two months of the current year.

Copyright © 2019 The Institute for Advanced Financial Education.

Balance Due Date

In general terms, a corporation's taxes are due two months after the corporation's tax year-end, except the following groups have a due date three months after the corporation's year-end.

a) The corporation was a CCPC through the tax year.
b) The corporation is claiming the small business deduction in the current year (or in the prior year) and,
    i. its taxable income in the prior year did not exceed the business limit; or
    ii. if there are associated corporations, the total taxable income of all associated corporations in the prior year did not exceed the business limit.

The term balance due date refers to the remaining income taxes owed at a corporation's year-end.

Theory of Integration

The federal and provincial governments strive to ensure that a taxpayer pays the same amount of income tax regardless of whether the income is earned directly by the individual (i.e. investment income) or indirectly through a corporation (i.e., corporation earning investment income and paying dividends to shareholder(s)). This concept is often referred to as the "theory of integration" which is an element of tax neutrality.

The theory of integration is designed to uphold the concept of neutrality. It is important that a country's tax system does not influence economic behavior nor distort natural behaviors that affect economic decision-making. Not all aspects of a tax system are neutral, but the goal should be to strive for neutrality, which is fundamental in the theory of integration. When the net economic effect of a decision is influenced by the tax consequences, there is a loss of neutrality.

Copyright © 2019 The Institute for Advanced Financial Education.

Dividend Gross-Up and Dividend Tax Credit

The dividend gross-up on Canadian taxable dividends received by individual taxpayers is designed to increase the taxable amount of a dividend to the equivalent amount of the pre-tax corporate income.

The dividend tax credit available to an individual in respect of Canadian taxable dividends is designed to approximate the amount of corporate income tax paid on the pre-tax corporate income that supports the dividend amount paid.

Active Business Income

The following table illustrates the theory of integration in respect of $100,000 of active business income.

The active business income could be earned in two ways:

Option 1: Through a corporation and distributed to the individual shareholder as a taxable dividend; or,

Option 2: Directly by the individual.

Copyright © 2019 The Institute for Advanced Financial Education.

Theory of Integration – Active Business Income			
Option 1 Income Earned Through a Corporation and Paid out to a Shareholder			
		Active business income above the small business limit	**Active business income below the small business limit**
Business income	A	$100,000	$100,000
Federal corporate tax rate	B	15%	10%
Provincial tax rate	C	11.5%	3.5%
Corporate taxes	D	$26,500	$13,500
Corporate cash position	E	$73,500	$86,500
Taxable dividend paid to shareholder	F	$73,500	$86,500
Dividend gross-up - 38% for eligible dividend - 16% for ineligible dividend	G	$27,930	$13,840
Taxable amount	H	$101,430	$100,340
Personal taxes - 53.53%	I	$54,295	$53,712
Dividend tax credit - 25.0198% of the taxable amount - 13.3176% of the taxable amount	J	$25,378	$13,363
Net personal taxes paid	K	$28,917	$40,349
As a percentage	L	39.34%	46.65%
Net cash retained	M	$44,583	$46,151

Copyright © 2019 The Institute for Advanced Financial Education.

Option 2 Income Earned Directly by the Individual		
Personal taxes if earned directly	N	$53,530
Net cash retain	O	$46,470

Observations:

ONE

- There is a 'tax-deferral' for income earned through a corporation to the extent the income is retained in the corporation and reinvested in the business or passive investments.
- In this case scenario, under option 1, the corporation has after-tax proceeds of $73,500 (for income above small business limit) and $86,500 (for income below the small business limit), as shown in row E. Under option 2, the individual has $46,470 of after-tax proceeds, as shown in row O.
- This means the funds available for re-investment are substantially more for the corporation compared with earning the income directly as an individual. The advantage for the corporation relative to the individual can be calculated by comparing rows E and O, as shown below.

E minus O		$27,030	$40,303

TWO

- The second observation is that there is a 'tax-cost' associated with earning income through a corporation and subsequently paying out the retained earnings as a taxable dividend to the shareholder.
- In this scenario, under option 1, assume the corporation pays a taxable dividend as outlined in row F, using all available after-tax cash. A shareholder who receives these dividend payments would net $44,583 and $46,151 after-tax, as noted in row M.
- This compares with Option 2, row O, where the individual would have net after-tax proceeds of $46,470, as shown in row O. The disadvantage for the corporation relative to the individual can be calculated by comparing rows M and O, as shown below.
- This analysis demonstrates there is a higher cost when income is earned through a corporation and flowed out directly to the shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

• This scenario is common when a shareholder's lifestyle requires all of the income of the business and there is limited opportunity for savings or reinvestment within the business structure.			
M minus O		($1,887)	($319)
THREE • Integration is not perfect and should consider the facts applicable to the actual situation. This would include provincial rates, which vary substantially across the country, together with marginal tax brackets applicable to the individuals. The example highlights the impact for Ontario at its 2018 top marginal tax bracket.			

Copyright © 2019 The Institute for Advanced Financial Education.

Capital Dividends

The Capital Dividend Account, commonly referred to by the term CDA, is a notional tax account applicable to private corporations. The CDA is designed to complete the system of integration across the Canadian tax system. In general terms, the intention is to allow certain tax-free amounts received by a private corporation to be distributed tax-free to Canadian-resident shareholders of the corporation.

Conceptually, the CDA is used to track a corporation's receipt of amounts that would not normally be taxable (i.e., life insurance proceeds in excess of the policy's ACB, non-taxable portion of capital gain, etc.) less the CDA payments made to shareholders. Subsection 83(2) is an election provision that sets out the rules under which a dividend may be paid as a capital dividend. Regulation 2101 sets out further conditions that apply in making an 83(2) capital dividend election, including a resolution by the board of directors and the filing of the election form T2054.

While a capital dividend is received tax-free by Canadian residents, American citizens living in Canada would have to declare and may be taxable on capital dividends when they file their U.S. tax returns.

Not all tax-free income received by a corporation will create a credit in its capital dividend account. The following are examples of tax-free income that does not create a credit in the capital dividend account:

- The receipt of income replacement insurance;
- The receipt of lump-sum disability buy-sell proceeds; and,
- The receipt of critical illness insurance.

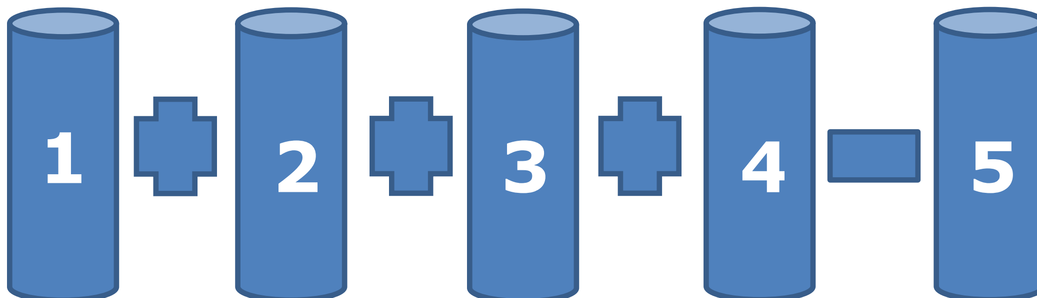
Copyright © 2019 The Institute for Advanced Financial Education.

Components of the CDA

Start by imagining distinct silos each of which represents a separate element of the CDA calculation. Below are the five more commonly occurring elements:

- **Silo 1**: Untaxed portion of a capital gain in excess of untaxed portion of capital losses;
- **Silo 2**: Capital dividends received from other corporations;
- **Silo 3**: Non-taxable portion of the economic gain on the pre-2017 disposition of eligible capital property;
- **Silo 4**: Life insurance proceeds in excess of the policy's ACB;
- **Silo 5**: Capital dividends paid.

Capital Dividend Account



Copyright © 2019 The Institute for Advanced Financial Education.

Integration of Components

Each of the five silos represents a unique item, and collectively they represent the CDA. There are other less-frequently encountered components, but, for the purposes of this course, the discussion will be limited to these elements.

EXAMPLE

GHE Ltd. has the following transactions in respect of its CDA.

- Capital gain of $120,000 on the sale of land realized in year 1.
- Capital dividend of $50,000 declared in year 2.
- Capital loss of $60,000 on the sale of land realized in year 3.
- Life insurance proceeds of $100,000 in year 4 (policy's ACB is $10,000).

	Silo 1	Silo 2	Silo 3	Silo 4	Silo 5	CDA Balance
Year 1 – capital gain	$60,000					
Sum of each silo at end of year 1	$60,000					$60,000
Year 2 – capital dividend paid					$50,000	
Sum of each silo at end of year 2	**$60,000**				**$50,000**	**$10,000**
Year 3 – capital loss	($30,000)					
Sum of each silo at end of year 3	**$30,000**				**$50,000**	**Zero**
Year 4 – life insurance				$90,000		
Sum of each silo at end of year 4	**$30,000**			**$90,000**	**$50,000**	**$70,000**

Copyright © 2019 The Institute for Advanced Financial Education.

Calculating the CDA

The amount of each component of the capital dividend account is computed separately on a cumulative aggregate basis. The period begins on the first day of the first taxation year ending after 1971 and after the corporation last became a private corporation, and ends immediately before the balance in the capital dividend account is to be determined.

EXAMPLE

JKL Ltd. is a private corporation incorporated on April 1, 1978 that has had a March 31st year-end since incorporation.

JKL Ltd. pays a dividend on April 1, 2019, and elects capital dividend treatment. The relevant period for its CDA calculation is April 1, 1978, to April 1, 2019.

Life Insurance Proceeds

The increase to the CDA occurs at the time the life insurance proceeds are received by the corporation rather than at the time of entitlement to the proceeds. This would cover situations where the life insurance proceeds are delayed because of an investigation.

Proceeds can also be received indirectly, as in the situation where a policy is collaterally assigned to a creditor, and the proceeds are payable directly to the creditor. From an economic perspective, the corporation has eliminated its debt with the collaterally assigned life insurance policy and is better off because of the transaction.

A CDA credit will arise in respect of group creditor insurance. For many years, the CRA did not recognize group creditor insurance. The stance changed because of a precedent-setting case before the Tax Court of Canada. The court interpreted the law as one that allows a CDA credit when corporate debt is repaid with group creditor insurance.

For the purpose of the CDA calculation, life insurance proceeds do not include accumulated dividends and interest thereon. These amounts are considered an “investment” with no life insurance element.

Copyright © 2019 The Institute for Advanced Financial Education.

Distributions from the CDA can be made as soon as the balance arises in the account. If, for example, a corporation receives life insurance proceeds early in its fiscal year, it can immediately pay out the resulting capital dividend.

CDA Election

In order to declare a dividend, the company's board of directors must pass a resolution setting out the amount of the dividend, the class of shares to which the dividend applies, and the timing of the dividend payment. The resolution would also indicate the directors' decision with respect to electing that the dividend be paid as a capital dividend.

From an income tax filing perspective, the CDA election is on form T2054 and must be accompanied by a certified copy of the directors' resolution. The election is due on the first day that the dividend becomes payable. The form plus the certified copy of the directors' resolution must be delivered to the CRA's office.

An election to designate a dividend payment as a capital dividend may be late filed, but there is a penalty equal to the lesser of:

i. one percent of the dividend for each month or part month between when the dividend is paid and when the late election is filed, and,
ii. $500 for each month or part month used in (i).

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

WXY Inc. declared a $100,000 dividend on May 1, 2019, to be payable on September 1, 2019. When WXY was preparing its corporate tax return for the April 30, 2019 year-end, they remembered a CDA balance from several years ago in respect to a disposition of capital property.

The board of directors met and passed an appropriate resolution on June 30, 2019, and the accountant filed form T2054 together with the resolution on July 5, 2020.

WXY is liable for a late-filing penalty of $917, derived as the greater of:

- 11 months (Sept 1, 2019 to July 5, 2020) times (1/12 of 1%) x $100,000 equals ($917); and,
- $500 x 11 months ($5,500).

Penalty Tax

Where a private corporation elects capital dividend treatment on a dividend in excess of its CDA account balance, a Part III penalty tax equal to 3/5 of the excess amount is imposed on the corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

FGH Inc. declared a $250,000 dividend to be a capital dividend based on their records of the CDA balance. FGH thought that their CDA balance was $270,000, an amount that would quite nicely cover a $250,000 capital dividend.

Unfortunately, FGH was reassessed for a prior year, which impacted the amount the firm had reported as a capital gain on the disposition of some land it owned. The land transaction was re-characterized by the CRA as business income rather than a capital gain.

The result of the reassessment meant there was never a capital gain so there was not a legitimate credit to the firm's capital dividend account arising from the disposition of the land. Given this outcome, the firm's capital dividend account balance was only $170,000 at the time a CDA election was made on a $250,000 dividend.

This means that FGH over elected capital dividend treatment by $80,000, which will result in a penalty of $48,000 (3/5 x $80,000).

Timing of a CDA Payment

One advantage of a CDA credit is that the tax-free capital dividend paid out to shareholders as a result of the credit does not have to be paid in the same year the credit was created; the declaration of the capital dividend can be deferred to future taxation years where appropriate.

For example, a CCPC can distribute tax-free capital dividends in future years when the shareholders are in high marginal tax brackets and can declare taxable regular dividends in years when the shareholders are in either lower marginal tax brackets or have tax losses from other sources that exceed their income. In effect, the timing and application of the CDA credit can be managed to yield the most advantageous results for the benefit of current (or future) shareholders of a private corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

CDA Recap

The CDA allows a private corporation to pass through certain non-taxable receipts to its shareholder(s). This is an important notional tax account that helps ensure a certain level of tax integration, providing similar effective tax rates whether the income flows directly on a personal level or indirectly through a corporation.

Generally speaking, there are four non-taxable items that receive this capital dividend treatment:

- Non-taxable portion of net capital gains;
- Non-taxable portion of the gain realized on the pre-2017 disposition of eligible capital property;
- Amount of life insurance proceeds in excess of the policy's ACB;
- Any capital dividends received from a subsidiary company.

The balance in the CDA is reduced by any capital dividends paid out to the company's shareholders.

Prior to electing to pay a capital dividend, it is important to ensure that there is an adequate credit in the CDA. Electing capital dividend treatment in excess of the CDA balance can result in a penalty equal to 3/5 of the excess amount. This penalty can be avoided if the corporation immediately makes appropriate income tax elections.

Timing of the Credits

Understanding when credits arise will help avoid penalties for excess capital dividend elections. Generally, the timing of credits to the account is as follows:

- The credit created in the capital dividend account by the untaxed portion of a capital gain occurs at the time of disposition of the property giving rise to the gain. Similarly, the deduction for the non-deductible portion of a capital loss also occurs at the time of disposition of the property.
- The credit for life insurance proceeds in excess of the policy's ACB occurs at the time the life insurance proceeds are received.
- The credit for capital dividends received occurs at the time the dividends are received.

Copyright © 2019 The Institute for Advanced Financial Education.

Each of the credits listed above will generally occur at the corporate level. However, CDA credits can sometimes originate in a trust of which the corporation is a beneficiary (i.e. where the trust distributes a capital gain or a capital dividend to the beneficiary corporation). Where that is the case, the credit to the corporation's account will occur at the end of the trust's taxation year.

The CDA can play an important role in tax planning, and it is important to respect the timing of additions to and deductions from the account in order to ensure that the capital dividend election will be effective and that the anticipated results will flow from the transaction.

Capital Dividend Trapped by Circumstances

In a 2013 Technical Interpretation, the CRA stated that a capital dividend could get trapped in a trust unless it is distributed to a beneficiary in the year of receipt.

A capital dividend can be received free of tax, and there are a series of mechanisms within the ITA to ensure this tax-free character is retained as the funds are passed through different types of entities and on to the ultimate taxpayer. In the following scenario posed to the CRA, the analysis shows that the tax-free nature can be lost if the timing of a distribution flowing through a trust is not properly aligned.

The situation presented by the taxpayer was as follows:

- An inter vivos family trust had been settled by the taxpayer;
- The taxpayer's spouse, minor children, and any company controlled by the taxpayer were named as beneficiaries of the family trust;
- The trust contained a provision such that the trust could not allocate income to "designated persons";
- The trust was the 100 percent owner of a private company;
- The private company paid a capital dividend on the shares owned by the family trust in the first taxation year of the family trust.

In simple terms, when individuals transfer or lend property to a corporation in order to provide a benefit to specific family members (i.e., designated persons, which include a spouse and minor children) while reducing the

Copyright © 2019 The Institute for Advanced Financial Education.

transferor's income tax liability, the corporate attribution rules may deem an interest benefit to the transferor in order to dissuade income splitting. However, there is a carve-out rule that provides that corporate attribution will not apply if those designated persons cannot access the income or capital of the trust. In the case presented for the CRA's technical interpretation, the trust contained a provision that disallowed income splitting with the taxpayer's spouse and minor children (designated persons) in order to meet the carve-out requirements. As a result, the taxpayer could escape the application of the corporate attribution rules.

What does all this mean? Good planning was used to ensure corporate attribution would not apply, but as a result, the taxpayer's spouse and minor children were not eligible to receive any payments out of the trust in the year the trust received the capital dividend.

In this case, the only other beneficiary of the trust was going to be a corporation controlled by the taxpayer. The wrinkle in the situation presented to the CRA was the fact that this beneficiary company was not set up until after the end of the trust's first taxation year. The inquiry to the CRA was whether the trust could allocate the capital dividend received in the first year of the trust to the new company in the second year of the trust and, therefore, create a CDA in the new company. (The ability of the trust to allocate a capital dividend to a specific beneficiary and the ability of a corporation to receive such income in its CDA are both parts of the mechanism to ensure such a dividend retains its tax-free character.).

The CRA responded that a capital dividend received by the trust could be allocated to a beneficiary of the trust and retain its character as a capital dividend, only if allocated in the year of receipt. However, if the capital dividend is not allocated to a beneficiary in the year of receipt, it would be reported by the trust as having been received and is added to the capital of the trust beginning in the subsequent year. At the beginning of year two, there is no carry-forward of income from the first year and the books from the prior year have been closed. Therefore, an unallocated capital dividend could be viewed as "trapped" in the trust under these circumstances; there was no beneficiary to whom it could be allocated in the year of receipt, and no ability to allocate it after that year.

When a tax plan is being developed, it is important to ensure all pieces are in order and ready to go. A step out of place in a tax plan can have unexpected results.

Copyright © 2019 The Institute for Advanced Financial Education.

Capital Gains Exemption

The Capital Gains Exemption (CGE) is a significant financial incentive designed to encourage risk-taking and investment in small Canadian businesses. Introduced in 1985, the CGE supports equity investment by individuals using the tax system to improve the balance sheets and financial health of many Canadian companies together with farm and fishing operations.

Originally the exemption took two forms:

1. A $100,000 exemption applicable to capital gains arising from the disposition of all capital property;
2. An enhanced $500,000 exemption, available only for capital gains arising from the disposition of:
    a. Qualified small business corporation shares;
    b. An interest in a family farm property.

The $100,000 general exemption has been eliminated, as will be discussed shortly. The $500,000 enhanced capital gains exemption has evolved over the past three decades. Changes arising in the federal government's 2015 budget mean we now need to look at different limits for:

1. Qualifying Small Business Corporation (QSBC) Shares;
2. Qualifying Farming and Fishing Properties (QFFP).

CGE Limits

In 2019, the maximum lifetime CGE limit is $866,912 of realized capital gains ($433,456 of taxable capital gains) arising from the disposition of QSBC shares and applies to dispositions after 2018. The $866,912 limit in 2019 represents an increase of 2.2% over the 2018 limit of $848,252.

The federal government's 2015 budget increased the maximum lifetime CGE to $1 million in respect of dispositions of QFFP after April 20, 2015 ($500,000 of taxable capital gains). The lifetime CGE for QFFP will remain at $1 million until the indexed lifetime base limit ($866,912 in 2019) exceeds $1 million. Then, the same lifetime limit, indexed to inflation, will apply to each of the QSBC shares and QFFP.

Copyright © 2019 The Institute for Advanced Financial Education.

Calculation of Additional Exemption

The additional exemption available to QFFP only is calculated as the difference between the base ($866,912) and $1 million. In 2019, an additional $143,088 of lifetime exemption is available for QFFP disposed of after January 1, 2019, and before January 1, 2020.

Keep in mind that if a taxpayer uses available QFFP beyond the available base limit ($866,912 in 2019), there would be nothing available for a future disposition of QSBC shares.

EXAMPLE

Carrie owns both QSBC shares and qualified farm property, both of which are different assets. She is thinking of selling both the shares (accrued gain of $1 million) and the farm property (accrued gain of $500,000).

Carrie would be wise to claim her QSBC capital gains exemption of $866,912 (2019 amount) against the sale of her QSBC shares before claiming her QFFP capital gains exemption of $133,088 ($1,000,000 less $866,912 claimed) against the sale of her QFPP.

If she claimed the QFPP exemption first, she would utilize $500,000 of her available CGE which reduce the available CGE on the subsequent disposition of her QSBC shares to $366,912 ($866,912 less $500,000 claimed against the QFPP disposition).

When working with clients who have both QSBC shares and qualified farm or fishing properties, a review of the specific facts will help to ensure the best financial outcome, if circumstances allow for planning.

Copyright © 2019 The Institute for Advanced Financial Education.

Claiming the QSBC before the QFFP	
Capital gain arising on the sale of the QSBC	$1,000,000
Capital gains exemption claimed (2019 amount)	$866,912
Net capital gain exposed to tax	$133,088
Capital gain arising on the sale of the QFFP	$500,000
Capital gains exemption claimed $1,000,000 less $866,912	$133,088
Net capital gain exposed to tax	$366,912
TOTAL capital gain exposed to tax	**$500,000**
Claiming the QFFP before the QSBC	
Capital gain arising on the sale of the QFFP	$500,000
Capital gains exemption claimed (2019 amount)	$500,000
Net capital gain exposed to tax	0
Capital gain arising on the sale of the QSBC	$1,000,000
Capital gains exemption claimed $866,912 less $500,000	$366,912
Net capital gain exposed to tax	$633,088
TOTAL capital gain exposed to tax	$633,088

Capital Gains Deduction

A taxable capital gain arising from the disposition of qualifying property is included in the taxpayer's income with an offsetting deduction, referred to as the capital gains deduction (CGD), of 50 percent permitted in calculating taxable income.

Copyright © 2019 The Institute for Advanced Financial Education.

$100,000 CGE

For a short period of time between approximately 1985 and 1994, individuals could claim $100,000 general capital gains exemption on many types of property. This exemption was repealed in February 1994 and, as part of the transition, individuals were permitted a one-time election whereby they could crystallize the exemption and embed up to $100,000 into the ACB of the selected property. To achieve this crystallization, taxpayers filed an election with their income tax return indicating the property upon which the ACB was to be adjusted.

Many individuals used this 1994 transition as an opportunity to crystallize the $100,000 general CGE by electing the amount of accrued gains in respect of their cottage or on accrued gains in a stock portfolio. Effectively, the amount of CGE crystallized is embedded in the ACB of the selected property. Because a capital gain is based on the difference between the FMV and the ACB of a capital property, by embedding the $100,000 general CGE into the ACB, it reduces the capital gain when the property is disposed of in the future. Note that to claim the full $100,000 CGE at that time, the spread between the FMV and the ACB had to be at least $100,000; otherwise, the amount crystallized was limited to an amount lower than $100,000.

The $100,000 of general lifetime CGE is looked at in combination with the current CGE available for QSBC shares and QFFP. Therefore, if an individual claimed any portion of the $100,000 in the past, this needs to be considered when making current claims.

Copyright © 2019 The Institute for Advanced Financial Education.

CGE Today

Today, properties qualifying for this special exemption amount include:

1. QSBC shares;
2. QFFP, which would include:
    - Ownership of a qualified farm business;
    - Ownership of shares in a qualified family farm corporation;
    - An interest in a qualified family farm partnership;
    - Ownership of qualified fishing property;
    - Ownership of shares in a qualified family fishing corporation;
    - An interest in a qualified family fishing partnership.

QSBC Shares

The CGE is available to qualifying taxpayers who dispose of shares of a QSBC. To qualify as a QSBC share, all of the following conditions must be present:

- The 90 percent test: At the time of disposition, the corporation must meet the definition of a small business corporation (SBC);
- The holding period test: Throughout the 24 months immediately prior to the disposition, the shares of the corporation were not owned by anyone other than the taxpayer, a person related to the taxpayer, or a partnership related to the taxpayer;
- The 50 percent test: Throughout the 24 months immediately preceding the disposition, while the shares were owned by the taxpayer (or related person or partnership), more than 50 percent of the FMV of the assets of the corporation were used in carrying on the active business of the corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Ricki owns 30 percent of the issued and outstanding common shares of Charco Inc. (CI), a Canadian small business corporation based in Saskatchewan, distributing electronic products throughout Canada. CI has been operating for 4.5 years.

Ricki purchased his CI shares from another shareholder 20 months ago, paying $250,000. CI was valued at $1,800,000, and held over $1,000,000 in GICs, at the time Ricki purchased his CI shares.

CI is currently valued at about $6.7 million, of which about $500,000 is reflected in CI's retained earnings and invested in GICs. The company qualifies for a 15 percent small business tax rate.

It is 2019 and Ricki's CI shares are currently valued at about $2 million. He has never utilized any capital gains exemption, so wants to now crystallize his full available amount ($866912, 2019 amount). Unfortunately, Ricki's shares of CI do not qualify for the exemption. First, he has not held the shares for the requisite 24-month holding period. Second, the company failed the 24-month 50-percent FMV test roughly 20 months ago because over 50 percent of the corporate assets were passive.

Ricki must wait about four more months to meet the holding period test and he will have to review the company's balance sheet before the CI shares he holds qualify for the CGE.

Copyright © 2019 The Institute for Advanced Financial Education.

Qualified Farm and Fishing Property

The exemption applies to capital gains arising from the disposition of QFFP, which includes real property, shares of a corporation, interest in a partnership, or eligible capital property. The property must have been held for two years by the taxpayer or a related party immediately prior to the disposition. In this case, related parties include the taxpayer's spouse or common-law partner, parent, or child.

In addition, the eligible property must qualify under a use test in order for the taxpayer to claim the capital gains exemption in respect of the particular property. The use test is measured by means of two criteria:

- The property must have been used in the course of carrying on farming or fishing business for two years immediately preceding the disposition of the property. It does not require that the taxpayer be the one carrying on the business but allows for the taxpayer, the taxpayer's spouse or common-law partner, or the children or parent of the taxpayer to have carried on the business.
- In cases where a qualifying individual operates the business, the gross revenue from the business, in any two years of ownership, must exceed that person's income from all other sources. Where the business is operated as a corporation or partnership, the individual operating the business must be actively engaged on a regular and continuous basis for at least two years.

Residency Requirements

The CGE is available to only those taxpayers who are resident in Canada in the year of disposition. This is true even though non-residents can be taxed in Canada on Canadian-source income (including capital gains).

Copyright © 2019 The Institute for Advanced Financial Education.

Converting Business Assets into Shares of a QSBC

As previously noted, only certain types of business property qualify for CGE. Individuals and partnerships operating farm or fishing business do not need to incorporate to access the CGE. However, this same treatment is not available for other types of businesses operating as a proprietorship or partnership.

In order for individuals or partnerships who do not meet the definition of a QSBC to avail themselves of the CGE, they must first incorporate. There are special rules available within the ITA for the transfer of certain assets from proprietorships and partnerships into a corporation. In a later module, the concept of a section 85 transfer will be looked at for transferring assets from a proprietorship to a corporation and deferring any immediate tax consequences that would occur on the transfer of qualifying assets.

Assuming that the newly formed corporation meets the definition of a QSBC, the taxpayer can either restructure the new corporation or dispose of the shares of the business (rather than the business assets) and crystallize the CGE.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE 1

Tanya operates a successful pet-grooming business out of a commercial building that she owns (not her principal residence). She purchased the building 12 years ago at a cost of $220,000, and it is now mortgage-free and valued at $600,000. If Tanya sells the building, she will incur a capital gain of $380,000, adding $190,000 to her taxable income in the year of the sale. Because Tanya's business is operating as a proprietorship, the gain will not qualify for the capital gains exemption.

As the FMV of the building continues to increase, so does the magnitude of the corresponding tax costs. For the purposes of this example, we will assume that capital cost allowance has not been claimed with respect to the building portion of the unit and that the main value of the business is the commercial unit.

Tanya could begin preparing today for a future disposition of the business, including the building. The first step to solving Tanya's problem is to convert her proprietorship into an SBC, which will allow her to subsequently dispose of the shares of her business, triggering a capital gain that could qualify for the exemption.

Tanya can subscribe to shares of a newly formed corporation and transfer her business, including the building, to the corporation. Section 85 of the ITA allows for the deferral of immediate tax consequences on many of the business assets transferred to the corporation. The steps associated with this type of transfer will be addressed in Section VIII of Module 3.

Assuming Tanya continues to operate her business under the umbrella of the new corporation, it can qualify as a QSBC. When she is ready to dispose of the business (including the building) through the sale of the shares, any gain ultimately triggered on the disposition of the shares of the corporation could qualify for the CGE. By restructuring, and operating the business through a corporate structure, Tanya is able to set the stage for future tax savings via the ability to claim CGE on the disposition of qualifying small business shares.

Note that the sale of the building by the corporation is a disposition of a capital asset by the corporation and would not result in the opportunity for Tanya to claim the exemption. The CGE can only be claimed on the disposition of the shares owned by an individual, which is why the business is now being operated through a corporation with Tanya as the shareholder. The building is simply an asset owned by the business.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE 2

Assume that Tanya continues to operate her business as a proprietorship. It is five years later and the building is now valued at $1 million while the ACB remains at $220,000. Tanya is nearing retirement and would like to transfer control of the proprietorship to her daughter when she retires. The transfer of the building will result in the realization of a $780,000 taxable capital gain that will not qualify for the CGE.

Similar to the prior example, Tanya can transfer the business assets to a newly formed corporation, using a section 85 election to defer any immediate tax consequences arising on the transfer of the building and any other qualifying assets. If Tanya continues to operate the business out of the corporation, the shares she owns of the corporation could qualify for the exemption as a QSBC. As discussed in the previous example, Tanya is not required to hold the shares for at least 24 months before qualifying for the CGE.

When Tanya is ready to retire, she can sell the shares of the corporation to her adult daughter for FMV (approximately $1 million based on no change in values) and the full gain of $780,000 can be sheltered by Tanya's available CGE ($866,912, 2019 amount), saving her taxes on the full amount of the gain.

In the example above, if Tanya were to transfer the shares to her daughter as a gift, it would result in the same tax consequences to Tanya – a capital gain sheltered by her available capital gains exemption. A gift of this nature to Tanya's adult daughter is quite permissible.

Copyright © 2019 The Institute for Advanced Financial Education.

Benefit of Restructuring the Business Operation

The previous examples were designed to show how restructuring the business operations can benefit an individual taxpayer. Without having restructured into an active business corporation, proprietors would not be eligible for the tax savings associated with the CGE. The examples are simplistic but, in reality, any unrealized capital gain shifted from the taxpayer as a proprietor to the newly formed corporation becomes an issue in terms of the share price should the share be sold.

The assets, held within the corporation, contain an embedded tax liability that would ultimately be reflected in the value of the shares. Effectively, the FMV of the shares disposed of by the original owner would not be a simple summation of the value of the underlying assets. Instead, there would need to be an adjustment to reflect the tax liability embedded in the corporation's assets (that were transferred from the proprietor). The FMV of the shares at the time of Tanya's disposition would likely be somewhat less than the full value of the underlying assets. This does not change the restructuring opportunity but is simply a valuation issue when assessing FMV. A comprehensive discussion of business valuation is beyond the scope of this module.

Dispositions for Tax Purposes

A disposition of capital property must be triggered in order to realize the capital gains that, in turn, can allow for the crystallization of the CGE. For many purposes, property is disposed of or deemed to be disposed of, for proceeds equal to its FMV. The amount of realized gain is the difference between the proceeds (or deemed proceeds) of disposition and the taxpayer's ABC on the property. Dispositions can occur in the following ways:

Copyright © 2019 The Institute for Advanced Financial Education.

- **Actual dispositions – voluntary:**
    - Sale
    - Disposition electing under section 85
    - Most transfers to a trust
    - Gifts
- **Actual dispositions – involuntary:**
    - Expropriations
    - Theft
    - Damage/destruction
- **Deemed dispositions:**
    - At death
    - Terminating Canadian residency
    - Change in use of property

Cumulative Net Investment Losses

A taxpayer's **Cumulative Net Investment Loss (CNIL)** balance is the cumulative excess (if any) of deductible investment expenses (i.e., interest paid, carrying charges and losses from passive investments in partnerships and limited partnerships, plus losses from rental real estate) over the cumulative total of investment income (i.e., interest; dividends; passive income from partnerships, limited partnerships, or rental property) since 1987.

A taxpayer's access to the CGE may be reduced (deferred) to the extent that the taxpayer has a positive balance in her CNIL account in the year in which a gain on qualifying assets is triggered.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

From 1988 to the present year, inclusive, Laila incurred deductible investment expenses totaling $98,400. During that same period, she reported taxable investment income of $57,200. As a consequence, Laila has a current CNIL balance of $41,200.

To the extent that a CNIL balance exists, an offsetting amount of taxable capital gains must be included in income (without access to the CGE) before the deduction can be applied against other qualifying gains.

EXAMPLE

In 2015, Alan triggered $200,000 of qualifying capital gains on the sale of shares that met the QSBC criteria. He has never utilized his available CGE, so he has $866,912 (2019 amount) available. Alan's CNIL account has a relevant balance of $22,300.

Alan will have to take $22,300 of taxable capital gains ($44,600 of net capital gains) into income for this year before being allowed access to $155,400 of CGE ($77,700 of the capital gains deduction). The additional $44,600 of CGE will, however, not be lost. Alan's access to the additional $44,600 is simply deferred until future taxation years when he has no CNIL balance. He will therefore carry forward an unused CGE of $711,512 ($866,912 (2019 amount) – $155,400) to future taxation years.

Copyright © 2019 The Institute for Advanced Financial Education.

The significance of an existing CNIL balance means that not all of a qualifying gain can be exempted by the taxpayer's available deduction. While any unused CGE can be carried forward, the taxpayer will need to have a transaction in the future that meets the qualifying criteria.

Taxpayers who have a CNIL balance and expect to claim their CGE in the future should plan in advance. Examples of strategies to help reduce a taxpayer's CNIL balance include:

- Consider paying dividends from the corporation to the shareholder in an amount that will offset the CNIL balance.
- Consider charging interest and claim the resulting income on any outstanding shareholder loans so to reduce the taxpayer's CNIL balance.

Allowable Business Investment Losses

Allowable Business Investment Losses (ABILs) arise from investment in the capital shares of, or loans to small business corporations. One-half of any such capital loss is an ABIL and may be deducted against any other forms of income, not just capital gains.

As with a CNIL balance, if a taxpayer has ABILs for the year in which she disposes of a property qualifying for the CGE, access to the exemption is deferred until her ABILs have been used to offset any taxable capital gain arising from the disposition.

EXAMPLE

Fred has been a serial entrepreneur throughout his adult life, starting many businesses over the years. Five years ago, he lost a business and reported a $200,000 ABIL, which he claimed against other income that year and the subsequent year. In 2019, Fred sold another business venture for $750,000 and intended to claim his available CGE to shelter the full gain arising on the share disposition. However, his ABIL claim will limit his CGE claim to $550,000 leaving him exposed to a capital gain of $200,000.

Copyright © 2019 The Institute for Advanced Financial Education.

Alternative Minimum Tax

When planning to use the CGE, it is important to recognize its use may trigger a temporary additional tax liability due to the application of the Alternative Minimum Tax (AMT) system. Although amounts of AMT paid may be refunded in future taxation years (should the regular tax liability exceed AMT tax liability), the taxpayer will nevertheless be out of pocket (without interest) for the amount of AMT currently payable.

This temporary issue arises from the fact that the effective inclusion rate on capital gains for AMT purposes is 80 percent, rather than the 50 percent inclusion rate under the regular tax system. This 80 percent inclusion rate is achieved because the AMT system requires the inclusion in income of an additional 30 percent of net capital gains above the 50 percent already included under the regular system. Both systems allow for the application of the CGE, if applicable; however, the realization of a significant amount of capital gains could result in an AMT tax liability that exceeds the liability otherwise owing under the regular system.

Planning for the Disposition

The issue from using the CGE typically arises when a taxpayer has a disposition that qualifies for the CGE but has very little other income in a particular year. As such, when triggering an event to which CGE applies, a review of the taxpayer's total expected income may help to identify potential AMT implications.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Ellen, the sole owner of XYZ Inc. (XYZ), has never used her capital gains exemption. A review of the qualifying criteria confirms that Ellen's XYZ shares meet the conditions of a QSBC. A friend has suggested that Ellen incorporate a private holding company (Holdco) and transfer her common shares of XYZ to Holdco using a section 85 election to trigger $866,912 (2019 amount) of the $1,200,000 of unrealized capital gain.

Ellen should first consult her tax advisor to ensure that the transaction will not create adverse tax consequences. Under the regular tax system, Ellen would be required to include 50 percent of the gain, or $433,456, in her income for the year of the transaction (not onerous, as her CGE would offset the reporting of the taxable gain).

However, under AMT, Ellen must report 80 percent of the $866,912 net capital gain ($693,530) as part of her taxable income for the year. Only $433,456 of this amount can be exempt from taxation, using Ellen's CGE, leaving an additional $260,074 of capital gains to be taxed in Ellen's hands, for the year under the AMT rules. This could result in a considerable additional current tax liability. While it is technically a refundable tax, the refund only occurs in future years when her regular income tax liability exceeds her AMT liability.

Crystallizing CGE

When a client is considering the crystallization of available CGE, it is prudent to ensure the implications of AMT have been considered in advance of any transaction.

The following example is a step-by-step walkthrough of the process for crystallizing a shareholder's available capital gains exemption.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

In December 2019, Paul owns 100 common shares of PQR Ltd., which are currently valued at $1,000,000. Paul would like to "crystallize" his available capital gains exemption. Paul's ACB in the 100 shares is nominal (say $100). Paul has never claimed any capital gains exemption so has the full $866,912 (2019 amount) available to him. Paul wants to minimize any immediate tax consequences. Paul has no CNIL balance.

To crystallize Paul's CGE

Paul would transfer the 100 PQR common shares to a newly established holding company, electing under section 85 at a transfer price of $867,012. The important elements of this transfer are depicted in the table below.

Section 85 Chart

Asset	FMV	Tax Cost	Elected Transfer Price (ETP)	Non-Share Consideration (NSC)	Shares of Holdco	Income Effect
Transfer 100 c/s of PQR from Paul to Holdco	$1 million	$100	$867,012	Nil	$1 million	$866,912 (capital gain)

In this case, Paul's ETP is $867,012, which is comprised of his current ACB of $100 (shown in Tax Cost column above), plus an additional $866,912 (equivalent to the 2019 maximum CGE). The $100 tax cost for the shares is transferred with the shares and results in no immediate tax consequences. The transfer price includes the full available CGE amount of $866,912, which will trigger a capital gain of $866,912; however, the full income effect will be sheltered by Paul's available CGE.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE CONTINUED

In the above transaction, Paul is transferring (effectively he is selling) his PQR shares to Holdco. It is important that the FMV of the assets that Paul is transferring to Holdco be equal to the FMV of the assets he receives in return (consideration) from Holdco.

FMV IN = FMV OUT

$1 million FMV of PQR shares = $1million FMV of Holdco shares

Paul's side of the transaction:

a. Disposing of PQR shares with original tax attributes of:

   ACB = $100; FMV = $1,000,000

b. Receives Holdco shares in return, with tax attributes of:

   ACB = $867,012 (ETP less NSC = $867,012 less nil)

   FMV = $1,000,000

   *Note: The PUC calculation is beyond the scope of this course.

c. Income effect:

   When the ETP is above the tax cost of the shares, it will trigger an income effect. In this case, the tax cost is $100, but the ETP was $867,012. This means $866,912 (the amount equal to the available CGE) will trigger a capital gain on this amount. However, the income effect is negated because Paul has $866,912 of available CGE to cover the entire income effect.

Holdco's side of the transaction:

Holdco now owns the PQR shares.

ACB = $867,012

PUC =$100 (note, there has been no change to the paid-up capital of PQR)

FMV = $1,000,000

Holdco is deemed to have paid Paul an amount equal to the ETP, $867,012, for the PQR shares, so that becomes Holdco's ACB of the PQR shares after the transfer.

Copyright © 2019 The Institute for Advanced Financial Education.

Paul takes back consideration of $1,000,000 on the sale (equal to the FMV of the assets he transferred in), and the ETP becomes his ACB of the Holdco shares.

Questions

- So, where is the $866,912 of CGE?
- Does Paul receive cash for the $867,012?

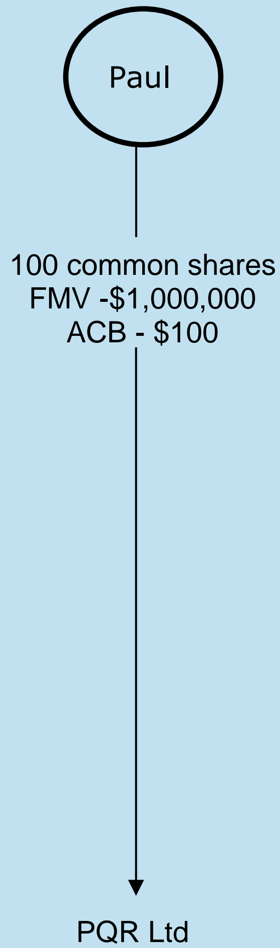
Answers

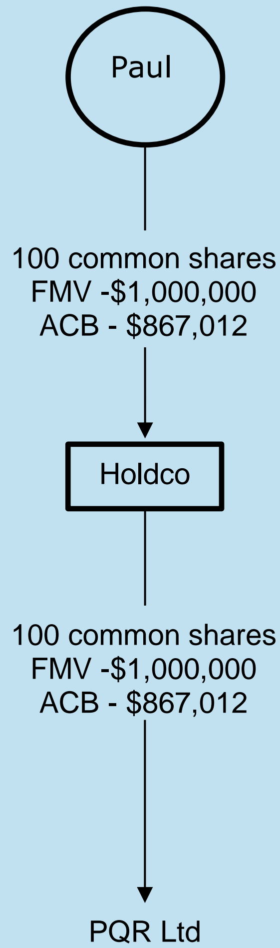
The $866,912 CGE amount is embedded as ACB in Paul's Holdco shares. This means when Paul eventually disposes of the Holdco shares, his capital gain will be FMV at the time less his ACB of $867,012 (which includes CGE of $866,912). Any attempt, by Paul, to capture the $866,912 as cash will result in an immediate deemed dividend due to specific anti-avoidance rules in the ITA (section 84.1, which is beyond the scope of the current discussion). A shareholder cannot convert his CGE into cash; crystalizing CGE simply means the CGE amount is embedded into the ACB of the shares, which will lower the capital gain at the time the shares are disposed of.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE CONTINUED

The following diagram depicts the structure before and after the transaction.





Copyright © 2019 The Institute for Advanced Financial Education.

Shareholder Remuneration & Benefits

This section examines the topic of shareholder remuneration from the perspective of earning a salary as a regular employee compared to receiving dividend income as a shareholder. The discussion extends into benefits and the resulting income tax implications that arise for shareholders. The section wraps up with the topic of shareholder indebtedness.

Salary versus Dividends

Shareholders of private businesses require regular cash flow to support lifestyle needs. The source of this cash is the corporation, but any withdrawal of money from the corporation typically has an income tax consideration. Planning to minimize tax and maximize cash flow is an important consideration that involves an analysis of whether the shareholder should take dividends or salary from the corporation.

Such analysis will involve analyzing the numbers to maximize cash flow using tax rates that consider the shareholder's province of residence. Other considerations include soft issues such as the impact on RRSPs, source deductions, etc.

Salary

Salary paid to the shareholder as an employee is a deductible expense for the corporation and taxable income to the shareholder (as an individual taxpayer). When salary is paid, Canada Pension Plan contributions are required. Given that salary is considered earned income for RRSP purposes, it creates RRSP contribution room for the shareholder.

Shareholders, who own 40 percent or more of the private company, and their immediate families, are not eligible to participate in Canada's employment insurance program. This means there is no employee withholding or employer contribution in respect to employment insurance.

Copyright © 2019 The Institute for Advanced Financial Education.

Dividends

Dividends are not deductible by the corporation because they are paid with after-tax funds. Dividends are, however, taxable to the shareholder (as an individual) and will have the dividend gross-up and dividend tax credit applied.

Salary versus Dividends

The following table highlights the process to be followed when analyzing whether salary is more efficient than dividends. The process begins with the family's need for cash flow, which is converted into a pre-tax salary or dividend. The table uses the 2018 tax rates applicable in the province of Saskatchewan. The shareholder is married, but the spouse had significant independent income so there is no spousal deduction.

Dividend versus Salary			
		Dividend	Salary
Corporate Level			
Business net income	A	$400,000	$400,000
Salary	B		$290,000
Federal corporate tax rate	C	10%	
Provincial corporate tax rate	D	2%	
Corporate taxes	E	$48,000	$13,200
Dividend paid to shareholder	F	$252,059	
Corporate cash position	G	$99,941	$96,800
Shareholder Level			
Salary received	H		$290,000
Non-eligible dividend received	I	$252,059	
Non-eligible dividend gross-up (16%)	J	$40,329	
Personal income taxes	K	$113,913	$112,779
Dividend tax credit	L	$39,076	
Personal cash position	M	$177,221	$177,221

Copyright © 2019 The Institute for Advanced Financial Education.

Numerical Observations

The example presented begins with $400,000 of business income (line A) and a shareholder who requires after-tax cash of about $180,000. To achieve this outcome under the salary scenarios, a salary of $290,000 would be required (line B). For simplicity, CPP contributions are disregarded as explained in the next section. Salary is deductible to the company, leaving the company with taxable income of $110,000. The after-tax outcome is $96,800 (line G).

For comparison, the dividend required to net the shareholder the same as a salary (line M is the same under both alternatives) would be $252,059 (line F). In this scenario, the full $400,000 (line A) of business income is taxed at the corporate level (lines E).

Both salary and dividend are taxable to the shareholder as an individual. As such, the scenario follows through the tax consequences associated with each type of income. The net after-tax income under the salary option is $177,221 (line M) compared with $177,221 (line M) under the dividend alternative.

In this situation, because there is high integration of the corporate and individual tax rates, there is effectively very little difference between the two outcomes (see line G). This could change depending upon the amount of income and provincial tax rates.

When a comparison is necessary, the steps outlined above should be repeated taking into account federal corporate and individual tax rates together with relevant provincial tax rates.

Copyright © 2019 The Institute for Advanced Financial Education.

Qualitative Observations

In addition to the numerical analysis, a decision as to salary or dividend should also take into consideration some or all of the following items:

- The payment of salary will create Canada Pension Plan contributions, which will create a pension plan for the shareholder. The 2019 contribution rate is 5.10 percent from the employer and 5.1 percent from the employee for a total of 10.2 percent of earnings, up to $57,400 of income. The value of the contribution and the value of the future pension plan should be taken into consideration in the salary versus dividend analysis. It is the shareholder who will have to put a value on this outcome.
- The payment of salary creates RRSP contribution room at a rate of 18 percent of earned income to a maximum of $26,500 (2019 room based on 2018 earned income). Keep in mind that earned income is impacted by many factors such as alimony payments and rental losses, so it is important to look at the individual shareholder's personal situation, not simply the total salary. RRSP contributions are tax deductible to the individual and the income earned inside the RRSP is tax-deferred. RRSPs will create retirement income later in life for the shareholder.

Benefits

Generally, a benefit is imputed any time the corporation provides something of value to the shareholder as an employee or because of her status as a shareholder. In addition, the benefit rule also applies when benefits are provided to non-arm's length family of the shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

Employee versus Shareholder Benefit

Shareholders of private companies are often involved in the day-to-day management of the firm, fulfilling the role of a senior employee. It is important to understand the differing roles – employee and shareholder – because some benefits are acceptable employee benefits and will be taxed more favourably than if the benefit is treated as a shareholder benefit. Whether a benefit accrues to a shareholder as an employee of the company or as a shareholder is not always a straightforward issue.

The first important consideration is a determination as to whether the benefit is taxable and, if so, is it taxable as an employee or a shareholder? A non-taxable benefit for an employee may be a taxable benefit to a shareholder, depending upon the circumstances. Both types of benefits are taxable to the recipient, but only employee benefits are deductible to the corporation.

The circumstances surrounding a benefit will be important considerations when arriving at a well-reasoned analysis. If the shareholder is a member of an employee group, all of whom are enjoying the same benefit, then it is likely that the benefit is an employee benefit. If the shareholder is enjoying a benefit none of the employees enjoy, then it is likely a shareholder benefit.

EXAMPLE

Mike is the sole shareholder of a private corporation, MooMaw Inc. Mike is also an employee of MooMaw, fulfilling the role of CEO. The company provides Mike with the use of a company car but no one else is provided with a company car.

The benefit will likely be treated as a shareholder benefit, as no other employees have use of a company car. It is likely that the car was provided to Mike in his role as sole shareholder who has decision-making authority over company decisions, including those involving the granting of benefits to himself.

Copyright © 2019 The Institute for Advanced Financial Education.

Shareholder Benefits

A benefit conferred on a shareholder by a corporation will typically create an income inclusion for the shareholder under subsection 15(1). These rules are designed to prevent shareholders from using or appropriating corporate assets without the payment of appropriate personal tax.

Private corporations create the most concern in this area because it is always possible for controlling shareholders to influence corporate transactions such that they receive a benefit otherwise unavailable in arm's length situations. In addition to existing shareholders, the benefit may apply to a contemplated shareholder.

A subsection 15(1) benefit is treated as ordinary income to the shareholder while the payment by the corporation is, typically, not deductible to the corporation. There is no mechanism associated with subsection 15(1) to reverse a shareholder benefit if it is subsequently repaid. This issue is an important consideration because it is often past the tax year when the issue of a benefit arises. A keen awareness of what constitutes a benefit is important to avoid unnecessary tax consequences.

The CRA's interpretation bulletin, IT-432-R2 (February 10, 1995), Benefits Conferred on a Shareholder suggests that the word "benefit" is broad enough to include:

- "A payment by a corporation to a shareholder otherwise than pursuant to a bona fide business transaction;
- An appropriation of a corporation's funds or other property for the benefit of a shareholder;
- Any other benefit or advantage conferred on a shareholder by a corporation."

The benefit might be conferred on the shareholder directly or indirectly, or on an individual or a corporation with whom the shareholder does not deal at arm's length, such as a family member.

Copyright © 2019 The Institute for Advanced Financial Education.

Bona Fide Transactions

When a shareholder is involved in a bona fide transaction, a shareholder benefit should not typically arise. IT-432R2 describes a bona fide transaction as one where "the terms and conditions are essentially the same as they would be if the transaction were entered into by parties dealing at arm's length."

EXAMPLE

The QR Corporation, a privately owned company, owns a pickup truck for business purposes that it no longer needs. The FMV of the truck is $9,800, and QR agreed to sell the truck to Andy, one of the corporation's three shareholders, for $9,800. Because the transaction occurred at FMV, no shareholder benefit accrued to Andy from the sale.

If Andy had purchased the truck at a value less than FMV, $5,000 for example, the transaction would not have been bona fide and a shareholder benefit should have been reported to Andy. The shareholder benefit would have been $4,800, which represents the difference between the FMV of $9,800 and the price paid of $5,000.

Taxable Shareholder Benefits

A shareholder benefit can arise in respect to a person who was not a shareholder at the time the benefit was conferred if, at the time of the transaction, it was contemplated that the person would become a shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

Corporate Assets

The classic shareholder benefit scenario is the use of corporate assets for personal enjoyment. The personal-use of corporate assets by a shareholder creates a shareholder benefit that must be reported by the corporation.

EXAMPLE

Go-Hi Inc. owns a panel truck for delivering goods. The majority shareholder allows his adult son to use the truck on weekends for his moving business. Go-Hi must report a taxable benefit to the majority shareholder for the fair market value of the truck's use.

Payment of Personal Expense

Another classic scenario that generates a shareholder benefit is the payment of personal expenses using corporate funds without reimbursement to the corporation. Personal expenses paid by a corporation on behalf of a shareholder would be considered a taxable benefit, as there is an appropriation of funds for non-business use. Some individuals may treat this as a shareholder loan, which means it is important to follow the shareholder loan rules discussed later in this section. Alternatively, if not recorded as a shareholder advance, caution should be exercised because the funds are being recorded inappropriately as corporate expenses.

Examples of situations where shareholder benefits can likely arise include:

- Free holiday trips for a shareholder or family members;
- Extinguishing debts/obligations of the shareholder;
- Additions or improvements to the shareholder's personal property using corporate assets or using corporate funds to pay for the expense;
- Purchases from the shareholder in excess of the FMV of assets sold or transferred to the corporation; and,
- Personal loans owed by the shareholder or related parties that are guaranteed or secured by corporate assets.

Copyright © 2019 The Institute for Advanced Financial Education.

To determine the value of the benefit, the company should use arm's length rates in a commercial setting. For example, if the shareholder is using a corporate-owned condominium for personal use, the benefit should be reported at the commercial rental rate for a comparable rental arrangement plus operating costs. There should be credit given to the shareholder for any consideration paid to the corporation for use of the asset.

Corporate-Owned Life Insurance

Corporate-owned life insurance where the corporation is the named beneficiary does not result in a taxable shareholder benefit. However, if the shareholder causes the corporation to name an individual as the beneficiary of the policy, a taxable shareholder benefit will arise. The CRA has indicated that they would charge a shareholder a taxable benefit equal to the benefit enjoyed; the benefit could be equal to the premium paid, the value of the coverage, or even the amount of the coverage.

EXAMPLE

CDE Ltd. holds a term life insurance policy on its shareholder's life, the beneficiary of which is the shareholder's spouse. The $4,650 annual premium paid by CDE Ltd. is reported to the shareholder as taxable shareholder benefit.

Loans to Shareholders

Section 15(2) of the ITA sets out the **shareholder loan** rules by beginning with a broad statement and then providing a few exceptions to the broad rule. The ITA states that a shareholder must include in income, as a taxable employment benefit, the amount of any debt or loan received from his or her corporation or a related corporation. This income inclusion can be avoided if the debt is repaid within one year of the corporation's taxation year-end. Most accountants will therefore not recognize a benefit unless the shareholder loan account is outstanding at two consecutive year-ends.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Bert owns Hi-Ya Ltd., which has an August 31 year-end. Bert borrows $100,000 from Hi-Ya Ltd. on September 1, 2017. The loan is still outstanding on Hi-Ya's next year-end, August 31, 2018. There is no shareholder benefit because the loan has not been outstanding at the year-end following the year in which the loan was incurred.

If, however, the loan to Bert remains outstanding on August 31, 2019, Bert will realize a taxable shareholder benefit equal to $100,000, which would be reported on his 2019 personal tax return. The loan is due within one year after the end of Hi-Ya's taxation year in which the loan was made. Therefore, it must be repaid by August 31, 2019.

Subsection 15(2.6) provides that subsection 15(2) does not apply if repayment is made within the time frame outlined above and repayment is not part of a series of loans or other transactions that involve repayments.

Repaying the Shareholder Loan

Repayment of a shareholder loan cannot be part of a series of loans and repayments. This rule is designed to prevent taxpayers from circumventing subsection 15(2) by making a repayment within the time frame but immediately initiating a new loan or new indebtedness (recycling the outstanding loan amount). A shareholder may still realize a shareholder taxable benefit if he participates in a continuous series of loans and repayments that meet the technical requirements but, in reality, is a disguise for a continuously outstanding loan.

Even if the shareholder pays interest on the loan, the interest payment does not change the application of a shareholder taxable benefit.

Copyright © 2019 The Institute for Advanced Financial Education.

Tax Deduction Available

If a shareholder eventually repays a loan to which a shareholder taxable benefit has been applied, the shareholder is entitled to a tax deduction, under paragraph 20(1)(j), for the amount in the year in which the loan is repaid.

EXAMPLE 1

If in the previous example, Bert has not repaid the loan by August 31, 2019, he will incur a taxable benefit in the 2019 taxation year. If he subsequently repays the loan on July 1, 2020, he would be entitled to a tax deduction of $100,000 on his 2020 personal tax return.

EXAMPLE 2

On October 1, 2018, Fun Times Inc. loaned its shareholder $100,000 at zero interest (at the time, the prescribed rate was 2 percent) to assist in a house purchase. The shareholder will realize a taxable shareholder benefit of $500 (2 percent times the amount outstanding, $100,000, for 3 months).

The reason for such stringent treatment of shareholder loans is to ensure that shareholders cannot directly or indirectly withdraw funds from the corporation tax-free (via the loan) when the loan would otherwise be treated as income if they were paid to the shareholder by the corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

Exception to Shareholder Loan Rules

The first exception to the broad rule is that no taxable benefit will be applied if the loan was made in the course of the lender's ordinary business of lending money. This makes sense; otherwise, shareholders would be treated differently than regular customers of the business.

The second exception encompasses four employee/shareholder situations. These exceptions require that the loan can be clearly shown to have been provided to the individual in his or her capacity as an employee, not as a shareholder. In addition, the arrangement must also contain bona fide terms of repayment within a reasonable time frame. The loan can be made with or without interest; however, to the extent that interest charges are less than the prescribed rate when the loan was entered into, a taxable benefit will be realized. It should be noted that any applicable interest must actually be paid within 30 days of year-end or a taxable benefit will be includable in income.

The following describes, in general terms, the four employee/shareholder exceptions:

- Minority shareholders
- Minority shareholders who are also employees are excluded from the benefit rule. For this purpose, minority is defined as a shareholder who owns less than 10 percent of any class of issued shares of the corporation (as long as they deal at arm's length with shareholders who own more than 10 percent). This class of shareholder is generally not in control of the corporation and therefore would not be in a position to give themselves a benefit to the detriment of the majority shareholders.
- Home loan
- A loan provided to an employee/shareholder to assist the individual in acquiring a dwelling that will become his or her home.
- Share purchase loan
- Loans to employees where the proceeds are used to buy shares directly from the corporation. To meet this exception the shares must be previously unissued, fully paid shares of the corporation. This means care must be exercised to track shares that are redeemed by the corporation so that these shares are not subsequently reissued to employee/shareholders using company debt for the purchase price.

Copyright © 2019 The Institute for Advanced Financial Education.

- Car purchase loan
- A loan to an employee/shareholder when the loan enables the individual to purchase a motor vehicle that will be used by the individual in his or her duties as an employee of the company. Consideration should be given to setting out the need for the motor vehicle in the employee's/ shareholder's employment letter.

When seeking to fit into any of the above group of shareholder/employee exceptions, care must be exercised to ensure that benefits are offered to all employees or all employees of a certain class (e.g. senior executives, vice presidents, or all signing officers). If the group of employees is coincidentally only shareholders, the CRA will take the view that the benefit is being provided to the individuals because of their status as shareholders and not by virtue of their employee status, in which case a taxable shareholder benefit will be assessed.

Note that while most employee benefits are deductible to the corporation, shareholder benefits are not. This results in double taxation – income is taxed once in the hands of the corporation (since there is no deduction), and again in the hands of the shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

Summary

After completing this module, you should be able to:

- Apply and evaluate the general tax principles of corporate taxation;
- Integrate the calculation, payment, receipt, and penalties associated with the capital dividend account;
- Synthesize the tax consequences in respect of QSBC shares and the capital gains exemption;
- Analyze shareholder remuneration and synthesize the issues arising from shareholder loans and benefits.

Copyright © 2019 The Institute for Advanced Financial Education.

Module 3: Tax Applications for Business Restructuring & Transition

Learning Objectives

Upon completion of this module, you should be able to:

- Identify, apply and synthesize the appropriate income tax techniques used to restructure a corporation;
- Identify, calculate, and mitigate the application of the corporate attribution rule and suggest planning opportunities to avoid its application;
- Understand and explain the basic buy-sell arrangements for shareholders of closely-held private companies and recommend one structure over another in a client-specific situation;
- Explain the tax implications of basic buy-sell arrangements and be able to reflect these in estate plans for the shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

Business Structuring

When there is a disposition of capital property, there is generally an immediate recognition of the accrued capital gain or loss that arises from the disposition. There are special rules in the Income Tax Act (ITA) that permit a disposition to occur without triggering immediate tax consequences. These rules typically apply in circumstances where the disposition does not result in an economic change in ownership.

This section looks at the rules associated with sections 85 and 86, which permit the transfer of an asset without causing immediate tax consequences.

Section 85

Overview

Subsection 85(1) of the ITA is an elective provision that allows a taxpayer, under specific circumstances, to transfer certain types of property and defer the recognition of any embedded capital gain. A section 85 election could be used under the following circumstances:

- By a sole proprietor to transfer business assets into a corporation;
- By an individual who wants to transfer a non-registered investment portfolio into an investment holding company;
- By a shareholder to transfer shares of one corporation into a holding corporation; and,
- By a corporation to transfer some or all of its assets into a subsidiary corporation.

In each of the transactions listed above, the transfer of the assets from the transferor to the transferee is done without any change in economic value to the transferor. This assumes, of course, that the transfer falls within the guidelines of the provision, and the FMV of the assets transferred equals the FMV of the assets received as consideration for the transfer.

Given the purpose of a section 85 election is to defer any immediate tax consequences, one would only take advantage of this election when there is an embedded capital gain in the asset.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

John owns a piece of land. His ACB in the land is $25,000, while the land is currently valued at $100,000. This piece of land has an embedded capital gain equal to $75,000 ($100,000 FMV less $25,000 ACB). If John wants to transfer the land to NewCo, a newly established corporation, he would want to use a section 85 election to defer the immediate tax result that would otherwise arise from this transfer. The transfer, from John to NewCo, is a disposition of the land, creating a $75,000 capital gain ($37,500 taxable capital gain) if a section 85 election is not made.

Conditions

The preamble of subsection 85(1) is as follows:

> *Where a taxpayer has, in a taxation year, disposed of any of the taxpayer's property that was eligible property to a taxable Canadian corporation for consideration that includes shares of the capital stock of the corporation, if the taxpayer and the corporation have jointly elected in prescribed form…*

The taxpayer, who is the transferor, can be an individual, trust, corporation, or partnership.

In order to utilize the benefits of subsection 85(1), the transaction must meet all of the following criteria:

1. The property transferred must fall within the scope of **eligible property**;
2. The recipient of the transferred property must be a **taxable Canadian corporation**;
3. The package of consideration received by the transferor must include shares of the recipient corporation;
4. The transferor and recipient corporation must file a **joint election** under subsection 85(1).

Copyright © 2019 The Institute for Advanced Financial Education.

Eligible Property

Only certain types of property are eligible for a tax-deferred transfer to a corporation using a section 85 election. Subsection 85(1.1) defines "eligible property," for purposes of the subsection 85 rollover, as:

- Capital property (depreciable and non-depreciable);
- Eligible capital property (i.e. goodwill, patents, etc.);
- Resource property;
- Inventory (excluding real or immovable).

Typically, property owned by a non-resident is not eligible for a section 85 election.

One of the most significant exceptions for the tax-deferred transfer is land inventory, which would be the case in respect of land developers.

The Transaction

The corporation receiving the property must be a taxable Canadian corporation, which is defined in subsection 89(1). In general terms, this is a Canadian corporation that is not exempt from tax.

In exchange for the assets being transferred to the corporation, the transferor receives property in which the FMV is equal to the value of the assets transferred. This is a very important element because if the package of consideration paid to the transferor, by the transferee, is more or less than the FMV of the transferred property, negative income tax implications will arise. The package of compensation can be comprised of cash, promissory notes, and shares of the corporation. The term Non-Share Consideration (NSC) is often used to describe any consideration that is not a share of the transferee.

An important requirement set out in section 85 is that the package of consideration received by the transferor, as payment for the asset transferred, must include at least one share of the transferee corporation. The share could be a common share or a preferred share. The client's objectives will generally determine which type of share is most appropriate in the circumstances. The CRA has established criteria as to specific share attributes they feel must be included in some circumstances. For example, a retractable feature (callable at the option of the holder) is an important characteristic in an estate freeze that involves preferred shares.

Copyright © 2019 The Institute for Advanced Financial Education.

Elected Transfer Price

A section 85 election must be made for each asset being transferred and allows the parties to the transaction to agree upon a transfer price (referred to as Elected Transfer Price) for each asset being transferred between parties. The ITA defines a minimum and maximum range that can be used for the elected transfer price (ETP), and the parties to the transaction can agree on any amount between the minimum and maximum.

A general rule of thumb is that the ETP is the tax cost of the asset in order to achieve a tax-deferred transfer. Tax cost is the ACB for capital property and Undepreciated Capital Cost (UCC) for depreciable property. There are circumstances where the general rule of thumb does not apply, but this is beyond the scope of this course.

The elected transfer price becomes the proceeds of disposition for the transferor and the cost base for the transferee.

EXAMPLE (CONT'D)

John, as the transferor of the land, will have proceeds of disposition equal to the ETP and NewCo's ACB in the land will be equal to the ETP.

John's cost base in the land is $25,000. If John and NewCo agree on an ETP of $25,000, this $25,000 will be John's proceeds of disposition and NewCo's ACB of the land.

John's side of the transaction:

Proceeds of disposition (ETP) less ACB = Capital gain

$25,000: Proceeds of disposition (ETP)
$25,000: Less ACB of the land
NIL: *Equals* net income effect of the transfer

NewCo's side of the transaction:

ACB of the land: $25,000, which is equal to the ETP

Copyright © 2019 The Institute for Advanced Financial Education.

Choosing the Elected Transfer Price

Sometimes it is assumed that the chosen elected transfer price results in a tax-free transfer. However, the parties may agree to an ETP that generates income and/or a capital gain to the transferor. A transferor may want to elect a price higher than the cost base in order to recognize a capital gain, depending on the nature of the transaction. One reason for choosing a higher ETP is to create a capital gain that can be offset by available CGE (crystallizing available CGE) if the transferred property were qualifying shares. Another reason to choose an ETP higher than tax cost could be to create a capital gain that can be used to absorb a capital loss carry forward.

EXAMPLE

Dan wants to transfer his non-registered investment portfolio into an investment holding company, HoldCo. The portfolio is valued at $1,000,000, Dan's adjusted cost base in the portfolio is $600,000 and each investment is in a gain position. Dan and HoldCo elect to transfer the portfolio at $600,000 (ETP), which is equal to Dan's adjusted cost base ($600,000).

Dan can take back non-share consideration of $600,000 (promissory notes) and $400,000 of shares of the corporation. This satisfies the requirement that Dan must receive shares as part of the package of compensation and the requirement that the package of compensation from HoldCo is equal in value to the value of the portfolio (property transferred from Dan to HoldCo).

The HoldCo shares that Dan receives will have an ACB equal to zero based on the formula that says ACB is equal to the elected transfer price ($600,000) in excess of non-share consideration ($600,000 promissory note).

ACB = ETP less NSC
ACB = $600,000 (ETP) less $600,000 (NSC)
ACB = NIL

The $600,000 elected transfer price becomes the corporation's starting adjusted cost base of the portfolio.

The $600,000 elected transfer price becomes Dan's proceeds of disposition, resulting in a nil tax outcome.

Copyright © 2019 The Institute for Advanced Financial Education.

Tax impact = Proceeds of disposition less ACB
Tax impact = $600,000 less $600,000
Tax impact = NIL

Before the transaction, Dan had an accrued capital gain of $400,000 on his non-registered investment portfolio. After the transaction, Dan has an accrued capital gain of $400,000 on his shares of the new investment holding company. The FMV of the HoldCo shares now owned by Dan is $400,000 (recall that he received a $600,000 promissory note along with the $400,000 in shares for a total value of $1,000,000).

Accrued gain of HoldCo Shares
Accrued gain = FMV less ACB
Accrued gain = $400,000 less Nil
Accrued gain = $400,000

Now, assume Dan had an investment loan of $500,000 associated with his non-registered investment portfolio. Dan is permitted to transfer the loan to HoldCo along with the portfolio. Anytime there is an assumption of debt owing by the receiving corporation, the debt assumed is treated as non-share consideration.

There are limits to the amount of non-share consideration included in the total package of consideration, in order to avoid an immediate tax consequence. Often the maximum amount of non-share consideration is limited to the ACB of the asset. There are, however, tighter restrictions when the asset transferred is a share and the transfer is to a non-arm's length corporation and the transaction falls within the scope of section 84.1.

In this case, Dan can receive total non-share consideration equal to the ACB of the transferred portfolio ($600,000). Because the loan transferred with the portfolio is valued at $500,000, the outstanding loan represents non-share consideration. This limit additional non-share consideration to $100,000; otherwise, a tax consequence arises.

This means Dan receives $600,000 in NSC comprised of the $500,000 loan assumed by HoldCo and a $100,000 promissory note. The balance of the $1,000,000 owed to Dan is comprised of $400,000 of HoldCo shares. HoldCo's assumption of the outstanding loan in respect of the portfolios reduces the amount of promissory notes that Dan could receive on the transfer.

Copyright © 2019 The Institute for Advanced Financial Education.

Case Scenario

Janet operates a sole proprietorship called Janet's Interiors. She has become very successful and feels that it is time to incorporate her business in order to:

- Benefit from the tax deferral on income not needed for personal living expenses;
- Add creditor protection for herself; and,
- Make it easier to fund her capital purchases.

Her new company will be called Janet's Interiors Limited (JIL).

The FMV of the business assets and liabilities in respect of Janet's Interiors is as outlined in the following table:

Business Assets of Sole Proprietorship		
Name	FMV	Notes
Chequing Account	$15,000	
Accounts Receivable	$90,000	Fully collectible, no bad debts
Inventory	$120,000	Cost is $110,000
Equipment	$50,000	Original cost is $75,000 and undepreciated capital cost is $35,000
Building	$125,000	Original cost is $100,000 and undepreciated capital cost is $95,000
Land	$75,000	ACB $70,000
Accounts Payable	$50,000	
Mortgage	$100,000	Secured by the land and building

Copyright © 2019 The Institute for Advanced Financial Education.

Based on discussions with her accounting firm's chartered business valuator, it has been determined that there was no goodwill in the business at this time. Janet was very successful but feels her success relates to her personal involvement with clients.

Janet does not need to use section 85 to transfer the chequing account, as there is no embedded capital gain. Similarly, there is no embedded accrued gain in the Accounts Receivable (A/R). She could simply transfer these assets to her newly established operating company, JIL, taking back a $105,000 promissory note, the FMV, as payment. For simplicity, the A/R is being treated as capital assets in this example. There is a possibility the A/R could be eligible for a section 22 election, which is beyond the scope of this material.

The remaining assets all have an accrued capital gain and all are eligible assets for a section 85 transfer.

The table below summarizes the important tax considerations, including the ETP and property received by Janet, for each asset transferred under a section 85 election.

Property transferred from Janet to JIL	FMV ($)	Tax Value ($)	ETP ($)	NSC received by Janet from JIL ($)	Shares of JIL received by Janet ($)
Inventory	120,000	110,000	110,000	110,000	10,000
Equipment	50,000	35,000	35,000	35,000	15,000
Building	125,000	95,000	95,000	95,000	30,000
Land	75,000	70,000	70,000	70,000	5,000
TOTAL	370,000	310,000	310,000	310,000	60,000
Assumption of debt				150,000	
New promissory note				160,000	

Copyright © 2019 The Institute for Advanced Financial Education.

The columns in the table are strategically selected to identify the key information that is completed on the CRA form T2057 (Election on disposition of property by a taxpayer to a taxable Canadian corporation) to report the election. Form T2057 requires both parties involved in the transaction to sign as confirmation of their joint election.

Let's look at each of the assets transferred.

Inventory: The ETP of $110,000 is exactly the same as the cost of the inventory. This means Janet will not report any income on the disposition. The combination of NSC ($110,000) and JIL shares ($10,000) together equals the value of the inventory transferred to JIL from Janet ($120,000).

Equipment: The ETP of $35,000 is exactly equal to the undepreciated capital cost amount of the equipment. Janet will report the proceeds of disposition of $35,000 on her CCA calculation resulting in no income effect.

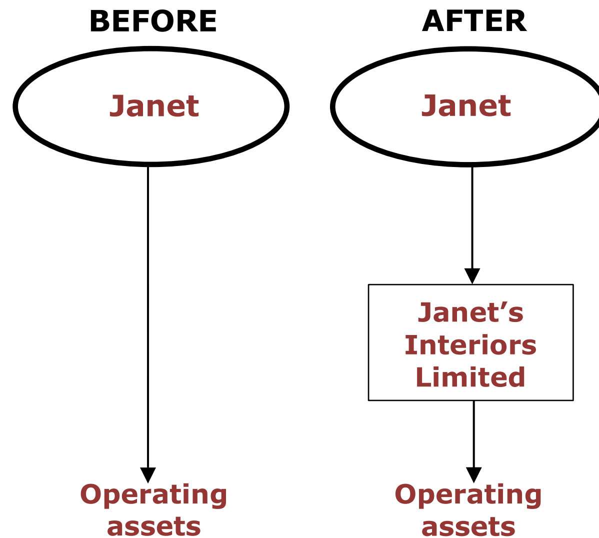
Building: Similar to equipment, the ETP is the undepreciated capital cost amount of the building. The result of a $95,000 ETP, equal to Janet's tax cost (UCC) of this asset means she has no capital cost allowance recapture or capital gain on a disposition.

Land: The $70,000 ETP equals Janet's ACB of the land, which means there is no capital gain to report.

Janet has transferred the business assets, valued at $370,000, as outlined in the table above to JIL. In return for the business assets, Janet receives shares of JIL valued at $60,000 and non-share consideration valued at $310,000 ($150,000 of assumed debt and $160,000 new promissory note). The $310,000 of non-share consideration is equal to Janet's tax cost of the assets transferred from herself to JIL. The ACB of the non-share consideration is equal to the FMV, which is $310,000.

The $60,000 of JIL shares will have an ACB of zero, which is derived from the ETP ($310,000) less the NSC ($310,000). Janet has an accrued gain of $60,000 in the JIL shares, the same as the accrued gain inherent in the assets she transferred.

Copyright © 2019 The Institute for Advanced Financial Education.



Corporations Using Section 85

Section 85 can be used by a corporation to transfer assets to another corporation. In the following example, a corporation uses section 85 to transfer a few select operating assets to a newly formed subsidiary.

EXAMPLE

KLM Inc. (KLM) is a successful business that has evolved over the years. Kevin is the founder and sole shareholder of KLM. The firm began manufacturing after-market automotive parts and now has expanded to include a worldwide distribution system and consulting division. As the company has grown, operating multiple divisions within one company has caused administrative stress and liability issues, so Kevin has decided to segment the consulting division into a subsidiary company.

The only assets required by the consulting group are the furniture and equipment; everything else is leased. The furniture and equipment is valued at $500,000; its original cost was $1,200,000 and its undepreciated capital cost is $450,000.

Copyright © 2019 The Institute for Advanced Financial Education.

If KLM were to simply transfer the furniture and equipment into a newly formed subsidiary without using a section 85 election, it would trigger a recapture of the capital cost allowance of $50,000.

Given that KLM wants to minimize any immediate consequences arising from the asset transfer, KLM and the subsidiary can jointly elect to transfer the furniture and equipment using a section 85 election. By using an ETP of $450,000 (the UCC or tax cost of the property), KLM can defer any immediate tax consequences arising from the transfer.

Section 85 Chart	
Asset	Transfer furniture & equipment from KLM to sub
FMV	$500,000
Tax Cost	$450,000
Elected Transfer Price (ETP)	$450,000
Non-Share Consideration (NSC)	$450,000
Shares of Subco	$50,000
Income Effect	Nil

As outlined above, the ETP of $450,000 results in no immediate tax consequences. In return for the assets transferred, KLM receives a $450,000 promissory note (NSC) together with $50,000 of Subco shares.

Copyright © 2019 The Institute for Advanced Financial Education.

Holding Companies Using Section 85

Section 85 can be an ideal tool to interpose a holding company between the current shareholder and the operating company. Under the current scenario, the shareholder owns the operating company directly, whereas, after the section 85 reorganization, the shareholder continues to own the operating company but does so indirectly through ownership of the holding company.

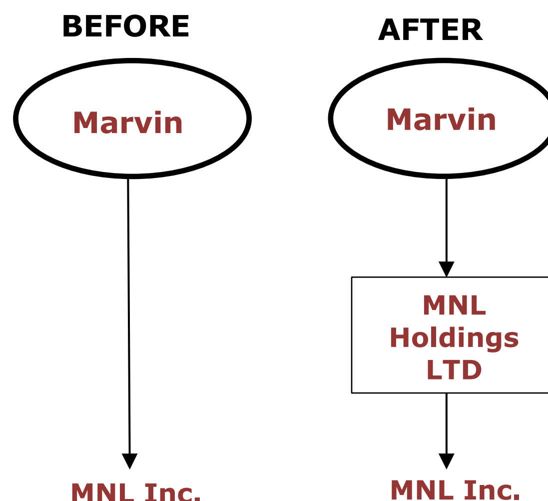
EXAMPLE

Marvin owns MNL Ltd., which is a successful pharmaceutical manufacturer. Excess funds, beyond the money required for the day-to-day operations of MNL, are accumulating within the firm. This concerns Marvin because the nature of MNL's business creates product liability issues, which could unnecessarily expose the excess funds to seizure.

Marvin has been advised that he should interpose a holding company between himself and MNL. The new holding company could hold excess funds, removing them from the reach of MNL creditors.

Marvin, the sole shareholder, owns 100 issued and outstanding common shares of MNL. His total ACB in the MNL shares is $1,000. MNL has been recently valued at $5,000,000.

Marvin transfers his 100 common shares of MNL to Holdco (a newly formed holding company) taking back 100 common shares of Holdco as consideration for the exchange. Provided Marvin and Holdco select an ETP of $1,000, there are no immediate tax consequences arising from the transfer.



Copyright © 2019 The Institute for Advanced Financial Education.

Transferring Eligible Assets

The use of a section 85 election to transfer eligible assets is a widespread planning technique. The examples outlined above demonstrate a few business scenarios where using a section 85 election can be a valuable tool to shift assets while meeting a client's objectives. To summarize, the examples looked at:

- Transferring eligible assets from an individual to a corporation;
- Implementing a strategy that sheltered valuable assets from creditors;
- Moving assets between corporate divisions.

While a section 85 election appears straightforward, care should be taken to ensure the transaction is completed correctly to avoid unforeseen tax consequences. The following are examples of common issues that can arise.

The package of consideration received by the transferor in return for the assets transferred must be equal to the FMV of the transferred assets. Remember → "fair market value in" must equal "fair market value out."

- It is essential that a valuation be completed on both the property (going "in") transferred to the transferee corporation and the property (going "out") received back by the transferor from the transferee. For this reason, any promissory notes taken back as consideration should either pay a commercial rate of interest or be a demand note to substantiate the value assigned to the promissory note. If the shares are preference shares, they should be retractable, which means that the shareholder has the right to demand redemption of the shares by the corporation at any time.
- Failure to transfer assets for FMV will result in negative tax consequences, which will vary depending upon whether the consideration received is too high or too low.

Copyright © 2019 The Institute for Advanced Financial Education.

Section 86

Section 86 of the ITA, often referred to as a share for share exchange provision, allows a taxpayer to exchange all of his shares of a particular class of shares for another class of shares of the same corporation on a tax-deferred (rollover) basis. The ACB of the old shares becomes the ACB of the new shares. Similarly, the paid-up capital of the old shares becomes the paid-up capital of the new shares.

To meet the requirements of this provision, the shareholder must exchange all of his shares of that particular class of shares. Under section 86, the rollover is automatic, which means there is no opportunity to elect a transfer price; the transfer price is automatically assigned. A section 86 transfer does not require the taxpayer to file any notification or paperwork with the CRA. Of course, appropriate written legal documentation is required to reflect the share redemption and issue. The CRA suggests articles of incorporation should be amended appropriately.

The preamble of section 86 is as follows:

> *Where, in the course of a reorganization of the capital of a corporation, a taxpayer has disposed of capital property that was all the shares of any particular class of the capital stock of the corporation that were owned by the taxpayer at the particular time (in this section referred to as the "old shares"), and property is receivable from the corporation therefore that includes other shares of the capital stock of the corporation (in this section referred to as the "new shares"), the following rules apply:*

The key aspect is the phrase "all the shares of any particular class of the capital stock of the corporation that were owned by the taxpayer at the particular time." This means the taxpayer must exchange all of the shares of the class owned by the shareholder. This requirement applies to that single shareholder who is undertaking a section 86 reorganization; other shareholders who own the same class of shares are not affected and do not have to participate in order for section 86 to apply.

Copyright © 2019 The Institute for Advanced Financial Education.

Implementing Section 86

Many times, section 86 is used to freeze a shareholder's position and facilitate the introduction of the next generation as the owners of new growth (common) shares. Section 86 can also be used to facilitate a change of share attributes or rights of a class of shares; in this case, all shareholders, of the share class being changed, would need to undertake their own section 86 reorganization. By allowing a shareholder to exchange her shares of one class for the shares of another class, the rights and share attributes can be changed for that shareholder.

A section 86 reorganization is completed without the need for a second company – the exchange happens directly between the shareholder and the corporation. This differs from a section 85 transfer undertaken using a holding company. A second company entails annual financial statements, an annual corporate tax return, and general administration.

When undertaking a section 86 transaction, a shareholder can take back non-share consideration up to the amount of the PUC of the shares being exchanged. Note, however, the discussion in this course will be limited to a straight share for share exchange.

EXAMPLE

Kali owns VWX Inc., a successful fulfillment company in the internet retail space, currently valued at $5 million. Kali is approaching retirement and her youngest daughter, Siera, has been systematically assuming more responsibility in the business. Kali would like to introduce Siera into a share ownership position with the hope that she will eventually assume ownership of the entire business.

Kali undertakes the following steps in the reorganization of VWX.

1. Kali instructs her lawyer to amend the articles of incorporation of VWX to create a class of fixed-value, redeemable, retractable preferred shares that carry one vote each and are retractable by the owner.
2. Kali instructs her accountant's office to verify, through a formal valuation, the fair market value of VWX. The purpose of this valuation is to ensure, with certainty, the value of the business when introducing Siera as a shareholder. The chartered business valuation determines that the value of VWX is $5 million.

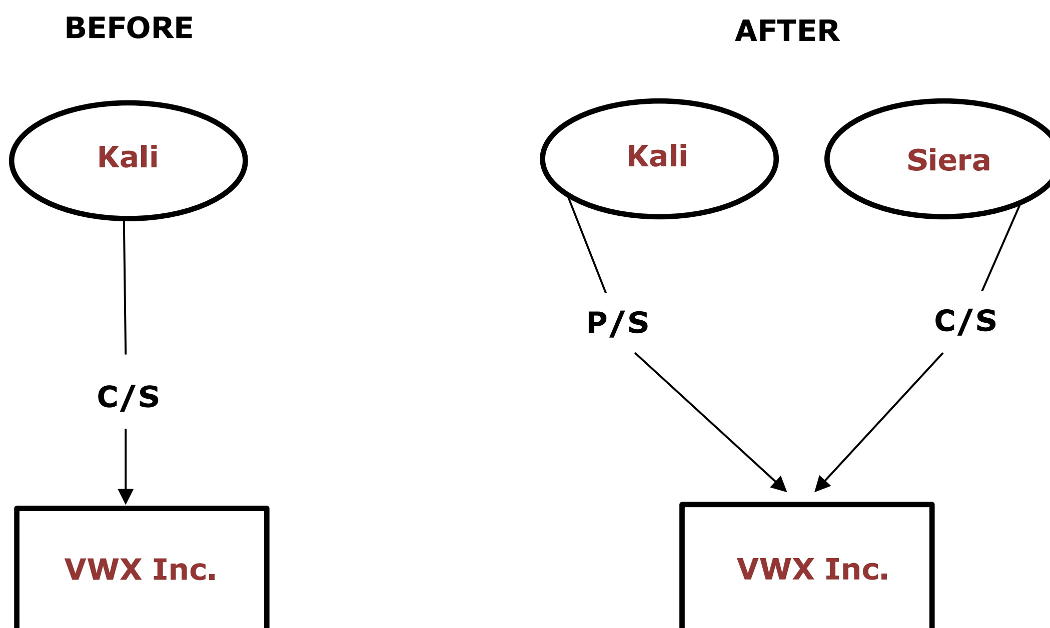
Copyright © 2019 The Institute for Advanced Financial Education.

3. Kali exchanges her 100 common shares for 50,000 new preferred shares, both valued at $5 million.
4. Siera subscribes to 100 new common shares, each with one vote, paying $100 in total.

After the reorganization, Kali has “frozen” her interest in VWX at $5 million and introduced Siera as the common shareholder. The share attributes allow Kali to retain control of VMX through the “votes” assigned to the preferred shares.

The tax attributes (ACB, PUC, ACB) of Kali’s preferred shares remain identical to those of her old common shares.

The following graphic summarizes the starting place and outcome.



Copyright © 2019 The Institute for Advanced Financial Education.

Comparison of Section 85 & Section 86

While the specific choice of which tax provision, section 85 or 86, to use in a client situation should be left to the client's tax professionals, it is important to understand how the provisions work, their similarities and their differences.

The table below presents a comparison of the elements of a section 85 transfer and a section 86 reorganization.

Comparison	
Section 85	**Section 86**
• Allows the election of a transfer price within certain parameters. Because the transfer price can be elected, it allows the selection of an amount that incorporates available capital gains exemption. By electing above tax cost, it will trigger income allowing the taxpayer to crystallize available capital gains exemption (embeds CGE into ACB of new shares).	• All aspects of the transfer occur automatically, including the transfer price. This means a taxpayer cannot crystallize available CGE when using a section 86.
• The parties involved must file a joint election with the CRA.	• No election is required.
• Typically, a new corporation is used in this type of transfer.	• The reorganization within the company using a share for share exchange.
• The transferor has significant latitude in terms of how many shares to transfer.	• The shareholder must transfer all of the shares she holds of that particular class.

Copyright © 2019 The Institute for Advanced Financial Education.

Internal Section 85 Transfer

Two of the biggest differentiators between a section 85 transfer and a section 86 reorganization are that a new corporation is often used with a section 85 and there is no ability to elect a transfer price with a section 86 reorganization.

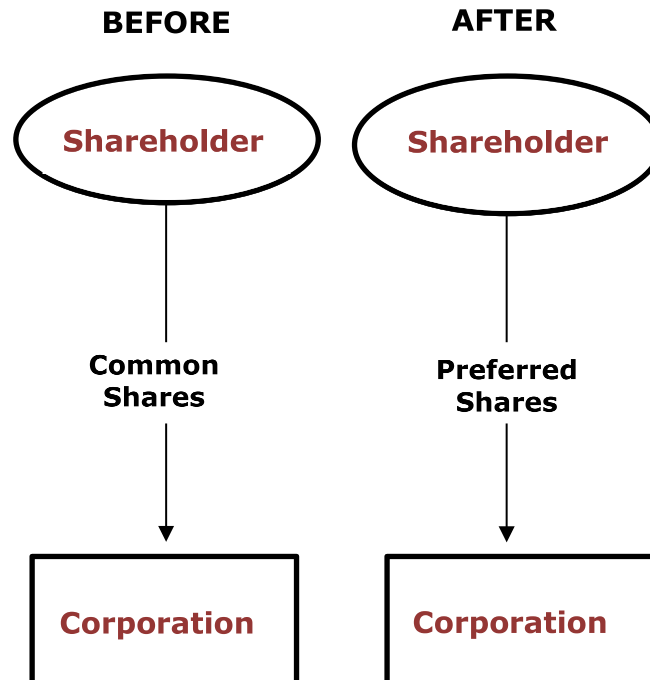
In some situations, it may be appropriate for the shareholder to transfer his shares of the corporation to the same corporation and elect under section 85. A close reading of the preamble to subsection 85(1), and the subsequent criteria highlights there is no specific requirement in the provision that requires the use of a second corporation. As such, a section 85 transaction can be undertaken without the use of another corporation but there are restrictions that must be observed. This type of transaction is referred to as an internal section 85.

The process for enacting an internal section 85 transfer is the same as a regular section 85 transfer but without a second corporation. The shareholder and corporation jointly elect a transfer price and file the appropriate paperwork to enact the transfer. Like a regular section 85 transfer, an internal section 85 allows the parties to choose an ETP that provides for the crystallization of available capital gains exemption.

With an internal section 85 transfer, the shareholder is required to take back property of equal value (FMV out) to that of the shares transferred into the corporation (FMV in). The property taken back can be comprised of non-share consideration and shares. However, this is where a significant difference arises when compared with the regular section 85 transfer. Non-share consideration on an internal section 85 transaction is limited to the PUC of the shares, similar to a section 86 reorganization. Quite often, the PUC of shares is nominal and no cash or promissory note (non-share consideration) is taken back when undertaking an internal section 85 transfer.

The outcome of an internal section 85 transfer is displayed graphically below.

Copyright © 2019 The Institute for Advanced Financial Education.



EXAMPLE

Sylvie owns 100 percent of the outstanding common shares of Store Inc., a manufacturing company valued at $1,000,000. She will retire soon and has been working very hard to develop a succession plan involving her daughter, Samantha, who has been a long-term employee of the company.

Sylvie has decided that she would like to:

- partially freeze her interest in Store;
- crystallize her capital gains exemption at the same time; and,
- have Samantha make a reasonable investment in the company.

Sylvie undertakes the following steps:

1) Sylvie instructs her lawyer to amend the articles of incorporation of Store to create a set of fixed-value preferred shares with each share carrying one vote. The shares will be retractable by the owner.

2) Sylvie instructs her accountant's office to arrange for a valuation of Store to ensure with certainty the value of the business when Samantha invests. The valuation undertaken by the chartered business valuator validates that Store is currently worth $1,000,000.

Copyright © 2019 The Institute for Advanced Financial Education.

3) Sylvie exchanges 90 of her 100 common shares (90 percent of her current ownership) for 90 new preferred shares with a fixed value of $10,000 each. Sylvie elects a transfer price of $866,912 (2019 CGE) to crystallize available capital gains exemption. The new preferred shares that Sylvie owns are worth $900,000 (90 shares at $10,000 each) and have an ACB of $866,912 (ETP which embedded the CGE amount into the basis of Sylvie's shares).

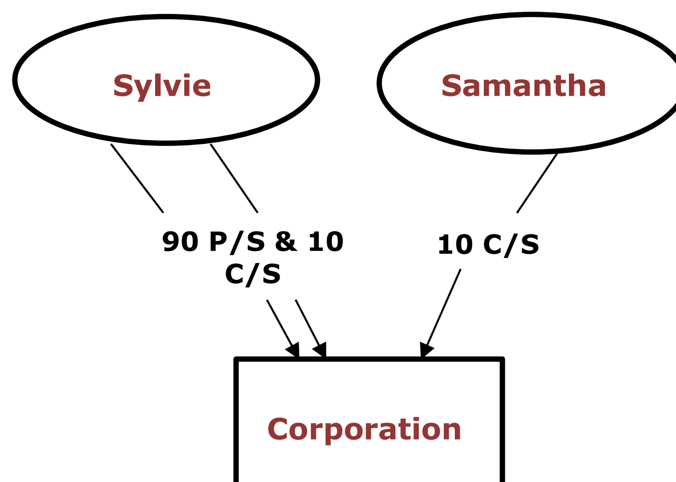
4) Samantha subscribes to 10 new common shares that are issued from treasury. She pays $100,000 in total. Her share subscription will give her an equal number of common shares to that of Sylvie. Samantha must pay $100,000 for this subscription because this is the FMV of Sylvie's remaining 10 common shares.

Sylvie has accomplished:

- a partial freeze of Store;
- introduced her daughter into ownership;
- allowed Samantha to invest in the company; and,
- crystallized her capital gains exemption.

This outcome was achieved using an internal section 85, without creating a new holding company.

The picture below shows the outcome of the transaction.



Copyright © 2019 The Institute for Advanced Financial Education.

Other Names

An internal section 85 has been described by many different names over the years. However, most of the names have only created confusion about how the transaction was completed. The following is a list of some of the names you may have heard used to describe an internal section 85.

- Offside reorganization: This is a poor name because there is nothing offside in the transaction.
- Dirty 86: The adjective "dirty" combined with the term "86" is intended to suggest that it has similarities to a section 86 reorganization. This is poor terminology, as it does not truly describe what is happening with the transaction.
- Dirty 85: The adjective "dirty" is a poor name because in reality, the transaction is just a section 85 reorganization.

Section 51 Conversion

Another method used to accomplish a reorganization without incorporating a second corporation is by way of a conversion in accordance with the provisions of section 51 of the ITA. If the share conditions attached to a particular class of shares allow the shareholder to convert those shares into shares of another class, the conversion can be accomplished on a rollover basis. If the shares do not provide a conversion privilege, such a right can be added by amending the corporation's articles of incorporation.

On a section 51 conversion, the package of consideration on the exchange is limited to shares with no ability to access non-share consideration. The advantage of using a section 51 conversion over a section 86 reorganization lies in the ability to convert only a portion of the shares owned by a shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

Corporate Attribution

Since Canadians were first introduced to income tax over a century ago, they have tried to avoid paying it, often by reducing the amount of taxable income they report. One way to do this is to income split among family members. Effectively, this means a family member with a high marginal tax rate shifts her taxable income to a family member with a lower marginal rate, thereby reducing her taxable income and saving the tax differential. The family unit pays an overall lower amount of income tax.

Higher net worth taxpayers might try to accomplish this by transferring or lending cash or other assets to a holding company in which their spouse and/or children own shares. This way, the income-producing assets in the holding company (and their associated income) are removed from the hands of the taxpayer, and the resulting income is transferred to the spouse and/or children and taxed at lower rates.

As these types of strategies grew in popularity, they attracted the attention of the Department of Finance. Legislation that prevents a number of income splitting strategies has been put in place including strategies that involve transfers to corporations. This section examines the anti-avoidance rules associated with corporate attribution.

A Penalty Provision

The corporate attribution rules, outlined in section 74.4 of the ITA, prevents taxpayers from reducing their family tax bill by splitting income with specific family members through a corporate structure. Effectively, corporate attribution acts as a penalty provision when there is a transfer of assets to a private company that includes shareholders who are related to the taxpayer. Related individuals, for purposes of corporate attribution, are more narrowly defined than simply non-arm's length. Corporations that meet the definition of a small business corporation escape the application of corporate attribution rules; however, the surprise that many seem unaware of is that corporate attribution is an ongoing test. While it may not apply at the time a transaction occurs, it has the potential to apply at any point in the future.

Corporate attribution could apply to a transaction at the same time as TOSI.

Copyright © 2019 The Institute for Advanced Financial Education.

The Conditions

The corporate attribution rules apply when all of the following conditions are met:

- The taxpayer has transferred or loaned property, directly or indirectly, to a corporation;
- A main purpose of the transaction is to reduce the income of the taxpayer and benefit a designated person;
- The designated person is a specified shareholder of the corporation;
- The transferor or lender (taxpayer) is resident in Canada; and,
- The corporation in question is not a small business corporation.

The only practical way to circumvent the rules is to ensure that the purpose test does not apply (i.e., no designated person benefits from the loan/transfer – although this is typically the purpose of these transactions), or that no designated person owns 10 percent or more of any class of shares of the corporation.

Much to the surprise of many, a section 85 transfer to freeze a shareholder's position meets the purpose test. The taxpayer is undertaking the freeze to limit her future tax liability and transfer future growth to someone else. If the "someone else" meets the definition of a designated person and specified shareholder, the transaction meets the conditions set out in the provision.

Purpose Test

Corporate attribution applies in circumstances where the purpose of the transfer or loan is to reduce the income of the transferor and benefit the designated person. If there is no clear documentation regarding the intent of the transaction, the CRA will apply its own interpretation. Further, even if documentation supports a specific "intent" other than income splitting for tax reduction, the transaction will be subject to the CRA's scrutiny.

Copyright © 2019 The Institute for Advanced Financial Education.

Designated Person

Subsection 74.4(5) defines the term **"designated person."** It says:

For the purposes of this section, designated person, in respect of an individual, means a person

(a) who is the spouse or common-law partner of the individual; or

(b) who is under 18 years of age and who

(i) does not deal with the individual at arm's length, or

(ii) is the niece or nephew of the individual.

This means a designated person includes a spouse or common-law partner of a taxpayer as well as individuals under that age of 18 who are non-arm's length to the taxpayer (i.e., minor children, grandchildren). The provision goes further and says nieces and nephews, under the age of 18, are also considered a designated person. The Department of Finance uses this extended definition that includes a minor niece and nephew because they want to limit adult siblings from using strategies that might involve using each other's children.

The rules apply until the day a person ceases to be a designated person (i.e. turns age 18 or spouses divorce). This timing differs from regular attribution that ceases in the year the minor person turns age 18.

Specified Shareholder

The term "specified shareholder" is used in the corporate attribution provision and is defined as a shareholder who owns:

- at any time in the year,
- not less than 10 percent of the issued shares of any class of the corporation or a related corporation (other than a SBC).

The above definition is easily understood when applied directly to an individual. However, when the definition is applied in the context of the beneficiaries of a trust that owns shares of the corporation, it is important to understand the scope can be broadened very quickly.

Copyright © 2019 The Institute for Advanced Financial Education.

Each beneficiary of a non-discretionary trust is deemed to own his or her own proportion of the shares as set out in the trust document. If, however, the trust is a discretionary trust, each beneficiary is deemed to own each share of the corporation that is owned by the trust. In other words, when a specified individual is a beneficiary of a discretionary trust that owns shares of the corporation, that single designated individual is deemed to own all of the shares of the corporation that the trust owns. As you can see, it would be very easy to surpass the 10 percent limit.

EXAMPLE

Benita transfers $200,000 in stocks and bonds to a private holding company owned by her children. The corporation does not meet the definition of a small business corporation. Benita can avoid the corporate attribution rules so long as none of the children is a designated person, which means they must all be over the age of 17.

Alternatively, assume Benita has three adult children and two minor children. She plans to have her children own shares of the corporation as beneficiaries of a trust. If it is a non-discretionary trust, it will be important to ensure the percentage of shares "owned" indirectly by each minor child is below the 10 percent limit in order to avoid the application of corporate attribution. If it is a discretionary trust, Benita needs to be aware that all of the shares owned by the trust will be deemed to be owned by each minor beneficiary.

Whether other income attribution rules would apply with respect to allocations to the minor children from the trust would depend on the nature of the income allocated.

The corporate attribution rules do not apply when the corporation meets the definition of a small business corporation. However, once a transaction occurs, the tracking of corporate attribution begins from that point forward, continuing indefinitely into the future. This means that while a corporation might be a small business corporation at the time a transaction occurs, it is important to ensure it remains a small business corporation until anyone who is a specified shareholder is no longer a specified shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Sixty-five year old John is the sole shareholder of Vio Inc., a small business corporation, that manufacturers widgets. John has decided to undertake a section 86 reorganization of capital to freeze his interest in Vio. John's much younger spouse, Dana, subscribes for new common shares of Vio.

Five years pass, and John has decided to wind-up the operation, selling all of the assets. The corporation now holds cash and earns investment income. As such, it no longer qualifies as a small business corporation. Corporate attribution will apply based on the original transaction, five years ago, because Dana meets the definition of a specified shareholder and the small business corporation exclusion no longer applies.

Deemed Income

The corporate attribution rules provide that the transferring taxpayer is deemed to receive taxable interest calculated as follows:

("Outstanding amount" x the prescribed rate of interest x number of days outstanding) – interest received, grossed-up dividends received, and split income dividends

The deemed interest amount is reduced by actual income (interest or dividends) received by the taxpayer from the corporation or any split income received by the other shareholders.

A $5-million outstanding amount over the course of a year results in a current year benefit of $50,000 at a one percent prescribed rate, whereas a prescribed rate of two percent would result in a benefit of $100,000.

The payment of dividends on the shares taken back is a direct offset in the calculation and often is a good option when corporate attribution applies.

Copyright © 2019 The Institute for Advanced Financial Education.

Outstanding Amount

The outstanding amount on which the annual deemed interest calculation is based is the FMV of the assets transferred or loaned to the corporation, less the FMV of any consideration received in exchange for the property. For this purpose, consideration does not include indebtedness from the corporation to the taxpayer, the shares of capital stock of a corporation, or the right to receive either.

EXAMPLE

Shareholder A freezes his position in AmCo, and a designated person subscribes to new common shares (entitled to all future growth of the company). Assume the transaction meets all of the conditions of 74.4, so corporate attribution applies. The “outstanding amount” in the deemed interest calculation includes the value of all shares and debt taken back as consideration for the transaction. If the shareholder froze at a value of $5 million and took back preferred shares valued at $5 million, the “outstanding amount” remains at $5 million on a go-forward basis.

Marriage Breakdown

The corporate attribution rules do not apply to a taxpayer’s spouse when there has been a breakdown of the marriage (i.e., the spouses are legally separated). This is true even though the corporate attribution rules may have applied before the separation, and is consistent with other income attribution rules applicable to separated couples.

Copyright © 2019 The Institute for Advanced Financial Education.

Safe Harbour Provision

There are often valid reasons for wanting to undertake a transaction that may be caught by the corporate attribution rules. To allow taxpayers to avoid this penalty provision, subsection 74.4(4) offers an exception that can be helpful when planning with a trust. In general terms, this "safe harbour" provision offers an exception to corporate attribution rules under specific conditions that restrict the rights of the beneficiary while he or she is a designated person in respect of the transferor.

The designated person may not receive or use any of the income or capital of the trust while she is a designated person in respect of the transferor. This restriction is to be set out in the trust document. In addition, the beneficiary must not have received or used any income or capital of the trust, and the trust has not deducted payments.

Copyright © 2019 The Institute for Advanced Financial Education.

Buy-Sell Arrangements

Individuals in business together should have a shareholders' agreement that addresses how the shareholders will conduct their affairs and the rights and/or obligations of all of the parties concerned.

Among other things that should be addressed within a shareholders' agreement are issues related to when, and under what terms, one shareholder is obliged to buy, and the other shareholder is obliged to sell, their respective shares of the company. This type of discussion would typically be documented as a buy-sell arrangement, which forms part of the overall shareholders' agreement.

Shareholders may want to sell, and the others may want to buy, their shares should one leave the employment of the company whether by choice, retirement, disability, or death. Sometimes the buy-sell is obligatory and sometimes optional, depending upon the particular circumstances. Once the triggering events have been established, it is usually good advice to consider planning for the funding of the buy-sell arrangement.

The discussion in this section typically refers to closely-held corporations.

Buy-Sell Provisions

What

In simple terms, a **buy-sell arrangement** is typically part of a larger agreement between business partners that states the conditions under which one partner will sell and the other partner will buy each other's shares.

Why

The shares of a private corporation are quite often the largest single asset owned by a business person. While these same shares may be worth a great deal, they typically are not very liquid. A buy-sell arrangement creates a market for these shares with pre-determined terms and conditions. For the deceased partner, the illiquid shares are turned into cash and her surviving

Copyright © 2019 The Institute for Advanced Financial Education.

family is relieved of the business risk. For the ongoing partner, it creates a level of freedom to run the business without new partners.

When

There are many **triggering events** that may cause the buying and selling of shares between partners. Triggering events may include death, disability, retirement, disagreement, divorce, incarceration, or termination of employment.

How

During the creation of the agreement, the partners need to agree upon the specific conditions under which the buying and selling of shares will take place. As well, the terms of the sale are established in the buy-sell agreement. Sometimes insurance is used to cover the risk of death and/or disability. With effective planning, insurance can also be used to facilitate the buy-sell triggered by the retirement of each partner.

Where

Every businessperson who owns shares of a private corporation needs to review how her shares will pass on to the next owner and under what circumstances. Proper planning can ensure that the transition happens as efficiently as possible, and will minimize unexpected events and issues.

Changing Trends

Managing Risk Exposure

As the Canadian population ages, it seems that there is an ever-increasing interest in our mortality. There is a growing trend towards ensuring that privately held small business operations are on a solid footing if one of the owners were to die prematurely. After all, it is characteristically the hard

Copyright © 2019 The Institute for Advanced Financial Education.

work and dedication of the owner/manager that contributes to the firm's success.

Perhaps the aging process of the baby boomer generation has sparked a much greater interest in this topic; or, it may be the evolving sophistication associated with the operation of many small businesses. Either way, the interest is clearly evident.

Life insurance is typically the funding vehicle of choice for most buy-sell arrangements established by closely-held small business corporations. It is not difficult to understand why, given the cost and benefits of this strategy. Businesses in this status are typically quite risk averse because of the magnitude of the financial consequences that could arise by a shareholder's untimely death. The loss of an integral player in the business operation naturally causes the surviving spouse of the deceased shareholder to become even more risk-averse.

And, what about the surviving shareholder? Does she want to become a business partner with the surviving spouse and/or family of the deceased shareholder? The answer to this question is most often, "Not if I can help it." A well-structured buy-sell arrangement addresses this issue and lowers the financial risk for not only the surviving spouse and/or family, but also the surviving partner.

The availability of business credit is essential to the ongoing operation of most organizations. Yet, lenders want to minimize their risk exposure not simply in relationship to a firm's ability to meet its repayment commitments under normal circumstances, but they also want assurances that the business is well-positioned to handle unexpected changes within its operations, such as the death of a significant shareholder.

The death of a significant shareholder has the potential to immediately increase the lender's risk exposure. To manage the financial exposure that could arise, a growing number of lenders are looking at the presence and quality of a buy-sell arrangement as a means by which to manage their risk exposure.

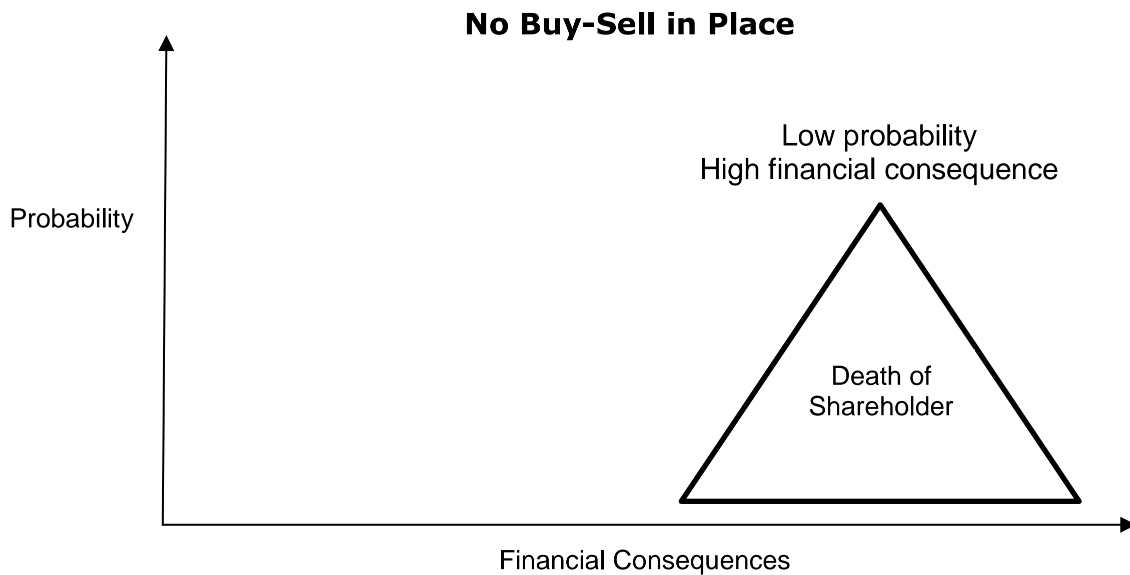
So far, the discussion can be summed up in two words – business continuation. Without a buy-sell arrangement in place, the risk exposure for everyone involved is significant and could lead to severe financial consequences, not only for the surviving spouse and/or family of the

Copyright © 2019 The Institute for Advanced Financial Education.

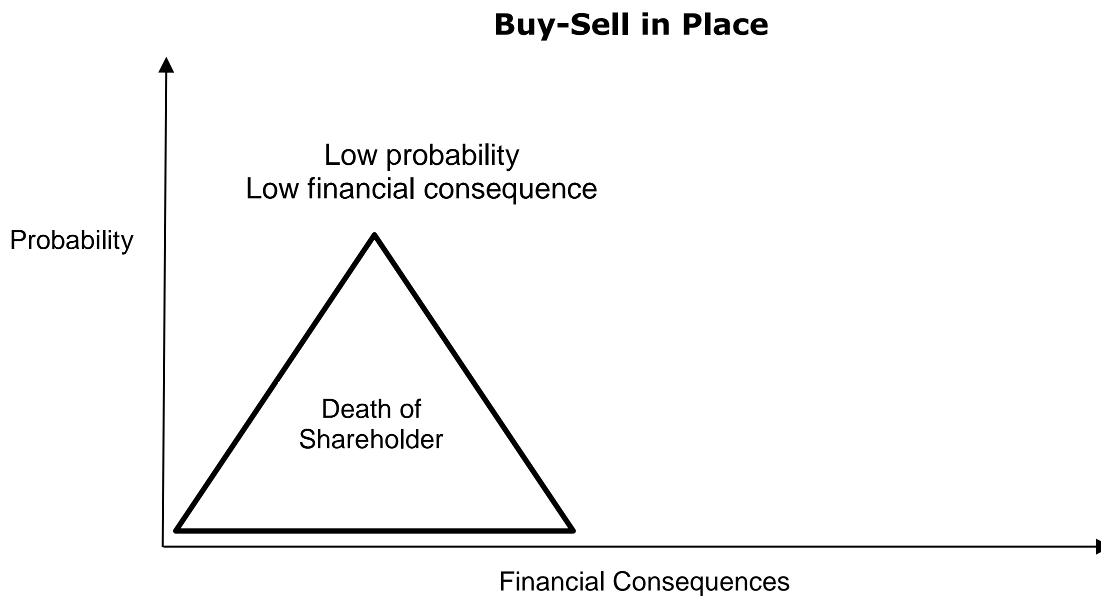
deceased shareholder but also for the surviving partner and the firm's significant creditors.

The graphs below show the difference in the financial outcome that may result from the death of a shareholder in an organization where there is no buy-sell arrangement in place as compared to an organization where a well-drafted and adequately funded arrangement has been implemented.

No Buy-Sell in Place



Buy-Sell in Place



Copyright © 2019 The Institute for Advanced Financial Education.

Developing Harmony

The meaning of “harmony” is a simple concept where there is agreement across all parties with no single party feeling that he has been disadvantaged. The words are much easier said than implemented, particularly as they relate to the transition of a family-owned business between two generations.

Today, the use of an independent facilitator to expedite the creation of a succession plan that results in harmony throughout the family-owned business is increasing in popularity. The buy-sell agreement is typically an integral aspect of the company’s succession plan. With the assistance of a knowledgeable, independent facilitator, a democratic process of discussion can evolve without creating an air of contention.

Dynamic Documents

A significant assumption made in the results shown in the second graph from Managing Risk Exposure is that the agreement is well-drafted and sufficiently funded. There is a trend towards establishing an automatic review period for arrangements, with some firms going so far as to document the timing and events that will trigger a review.

While it is difficult to peg a specific date or time on which all such arrangements should be reviewed, this issue should be looked at relative to the circumstances of each situation.

Issues that should be considered include:

- Adequacy of original funding;
- Expected growth rate of firm;
- Position of firm in business life cycle;
- Position of firm in product life cycle (if multiple products);
- Type of industry;
- Position within industry (i.e. leader, fast-follower); and,
- Addition of new partners.

This list is not intended to be all-inclusive but rather is a guide to help in determining the expected pace of change that a firm will experience as it

Copyright © 2019 The Institute for Advanced Financial Education.

goes forward. Changes in any of these areas have the potential to impact the effectiveness of the buy-sell agreement and its funding. In most cases, a well-drafted agreement will address a reasonable number of what-if scenarios. However, the agreement should not become a static document and should be reviewed and updated on a regular basis.

It is likely that if an agreement has been in place for any longer than five years, a comprehensive review of its content and funding is in order. Does the agreement achieve exactly what the shareholders would expect given today's circumstances? How significant are the gaps?

Appropriateness of Funding

The funding behind a buy-sell agreement is intended to create liquidity in the event of a shareholder's death. While life insurance is typically the most advantageous method by which to fund the agreement, it is not the only option. Some firms decide to use alternatives such as a sinking fund, employee instalment plan or simply to rely on a financing arrangement that is triggered by the shareholder's death.

If life insurance is not the current means of funding, how successful has the firm been in meeting its funding targets or structuring the arrangements? Is the firm willing to review insurance as an alternative? If so, the advantages of life insurance should be reviewed relative to the current program. Keep in mind that life insurance has tax advantages and can reduce the financial strain on the company.

For agreements that already utilize insurance, how appropriate is the current insurance program? This type of discussion could reveal the fact that when the agreement was put in place, a temporary type of insurance product was used to initially get the funding underway, with the clear intention of upgrading to a permanent product at a future date.

Upgrading to a permanent product does not necessarily mean re-underwriting. Instead, this is an ideal opportunity to utilize the conversion feature typically available on term insurance products.

Copyright © 2019 The Institute for Advanced Financial Education.

Buy Sell Agreements

There are three basic methods of structuring a buy-sell arrangement, which includes:

- A criss-cross structure;
- A promissory note structure; and,
- A redemption structure.

The use and effectiveness of any one of these methods will depend upon the specific facts and objectives of each situation.

The customization of the buy-sell agreement to meet the client's specific situation will not be without many complicating factors that will need to be considered as part of the final design.

Examples of such factors would include:

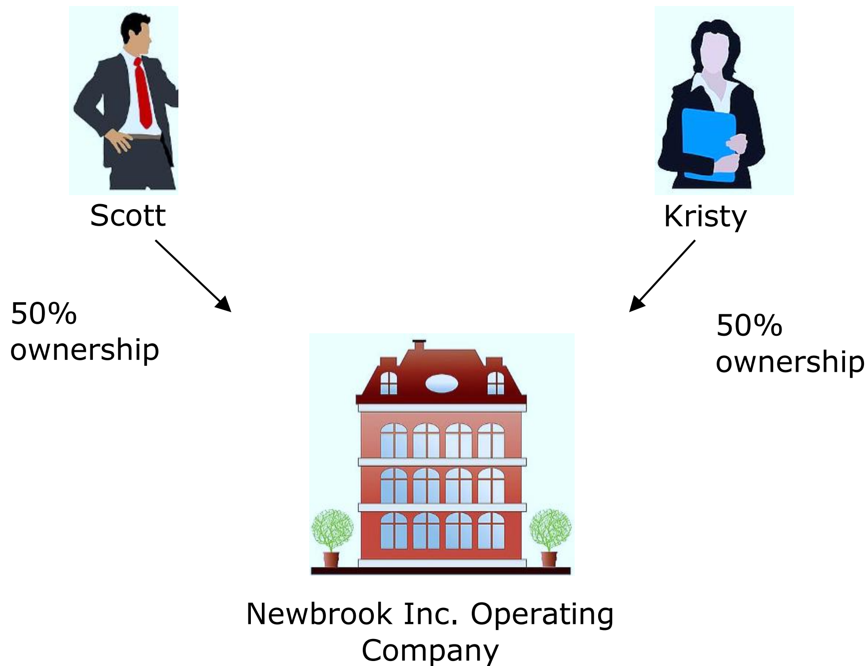
- Whether the shareholders have crystallized their enhanced capital gains exemption;
- The size of the ACB of the shares held by each shareholder;
- The amount of the paid-up capital for each shareholder;
- The presence of common and/or individual holding companies; and,
- Whether or not a spouse and/or children have to be integrated into the plan.

Explaining a Buy-Sell Arrangement

Consider the following fact situation that will be used in the explanation of the various methods of structuring a buy-sell arrangement.

- Scott and Kristy are business partners and sole shareholders who each own 50 percent of Newbrook Inc., an operating company;
- Newbrook is currently valued at $2,000,000;
- Kristy and Scott have a nominal ACB and PUC on their respective shares.

Copyright © 2019 The Institute for Advanced Financial Education.



Summary

- The collective shares of the operating company are worth $2,000,000;
- Scott and Kristy each have a nominal ACB and PUC on their shares.

Criss-Cross Method

Under the criss-cross method of a buy-sell arrangement, the agreement is between the shareholders. If one shareholder were to pass away prematurely, her estate would be obligated to sell the shares held by the deceased shareholder, and the surviving shareholder would be obligated to buy the shares held by the deceased shareholder.

Life insurance is held personally by the shareholders on the life of each other. Where there are two shareholders, there would be two insurance policies. Where there are three shareholders, there would be six insurance policies because each shareholder would own two policies – one on each of her partners. Where there are four shareholders there would be 12 insurance policies, with each owning three policies (one on each of her three partners).

Copyright © 2019 The Institute for Advanced Financial Education.

The criss-cross method is considered one of the most logical structures because the obligation to buy rests with the surviving shareholder, and the cost of insurance is borne by the party who receives the benefit of the insurance.

One drawback to the criss-cross method is the inability to ensure the policies are kept up-to-date and not collaterally assigned. This arises because the policies are personally owned and information about the policy is only delivered to the owner of the policy. Why is this a concern? The funds from the policy are slated for use in completing the buy-sell arrangement that affects the life insured's family. If the life insurance proceeds are impaired, the buy-sell arrangement could be easily compromised.

Income Tax Results

Deemed Disposition

Upon the death of a shareholder, the deceased is deemed to have disposed of all capital property for proceeds equal to its FMV.

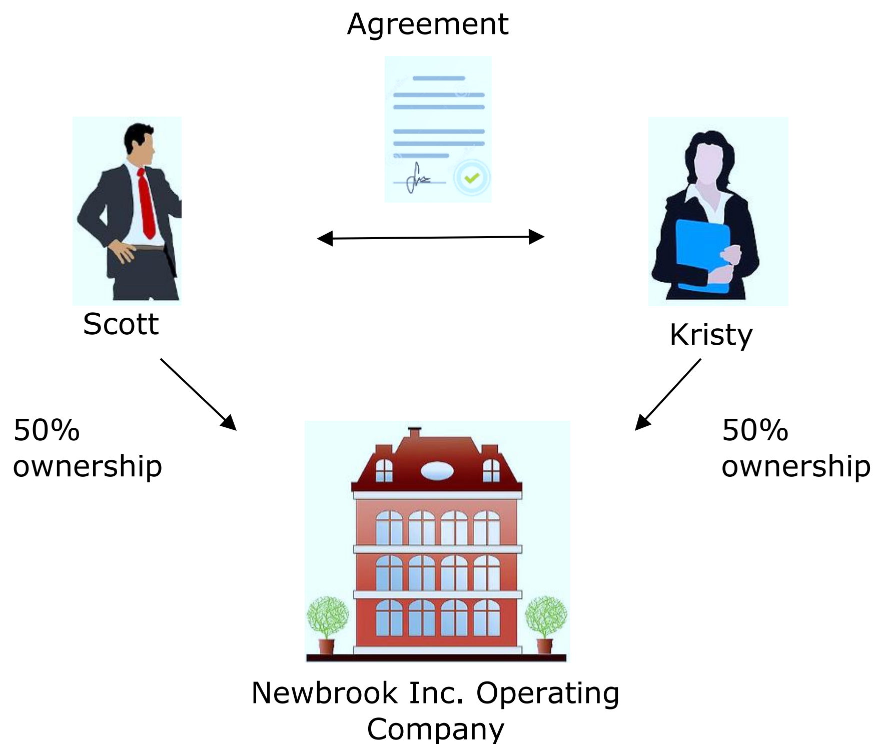
EXAMPLE

Assume Scott and Kristy have a criss-cross buy-sell arrangement in place. In this case, Scott owns a life insurance policy under which Kristy is the life insured and he is the beneficiary. As owner of the policy, Scott is responsible for payment of the premiums on the policy.

Conversely, Kristy owns a life insurance policy under which Scott is the life insured and she is the beneficiary. Kristy is responsible for premium payments on that policy.

Under this arrangement, upon Scott's death, he will be deemed to have disposed of his shares of Newbrook for proceeds equal to fair market value. Alternatively, upon Kristy's death, she will be deemed to have disposed of her shares of Newbrook for proceeds equal to fair market value.

Copyright © 2019 The Institute for Advanced Financial Education.



Summary

- Scott owns and pays for a life insurance policy on Kristy's life.
- Kristy owns and pays for a life insurance policy on Scott's life.
- If either Scott or Kristy should die, shares owned by the deceased shareholder will be deemed to have been disposed of for proceeds equal to their FMV.
- If either Scott or Kristy should die, the surviving shareholder will use proceeds from the life insurance policy to fulfill the terms of the agreement with a payment to the estate of the deceased shareholder.

This means upon the premature death of Scott, he will be deemed to have disposed of his shares of the operating company for proceeds equal to their FMV.

Since Scott's shares are subject to a buy-sell arrangement, the value assigned to the shares will be an indication of their FMV.

Copyright © 2019 The Institute for Advanced Financial Education.

Fair market value	$1,000,000
Deceased shareholder's ACB	Nominal
Capital gain	$1,000,000
Taxable capital gain	$500,000
Less enhanced capital gains deduction	Unknown
Net taxable capital gain	$500,000
Potential tax provision (assume 45% MTR)	$225,000

Copyright © 2019 The Institute for Advanced Financial Education.

Buying & Selling Shareholder's Shares

The buy-sell arrangement creates an obligation upon the estate to sell the deceased shareholder’s shares and on the surviving shareholder to buy the shares.

EXAMPLE (CONT'D)

The estate receives the shares from the deceased and is able to add the capital gain recognized by the deceased to the estate’s adjusted cost base of the shares. As a result, the estate does not have a capital gain on the disposition of the shares to the surviving shareholder.

Upon Scott’s death, his estate will receive the shares from him and will add the capital gain he recognized on his final tax return to the estate’s ACB for the shares. The disposition of the shares from Scott’s estate to Kristy will occur at the current market value of the shares, which is now equal to the estate’s ACB.

Proceeds of sale	$1,000,000
Estate’s adjusted cost base	$1,000,000
Capital gain	None

The surviving shareholder collects the insurance proceeds and uses the proceeds to buy the deceased shareholder’s shares from the estate.

The surviving shareholder will get a bump to her adjusted cost base and her accrued capital gain will stay the same.

The life insurance policy that Kristy holds on Scott’s life will provide her with $1,000,000 of insurance proceeds, which she will use to purchase Scott’s shares from his estate.

Purchase price for 50% of the shares	$1,000,000
Original cost for original 50% of the shares	Nominal
New adjusted cost base	$1,000,000
Fair market value of the company	$2,000,000
Kristy's accrued capital gain	$1,000,000

Kristy’s ACB will be bumped to $1,000,000 from the previous nominal amount while her accrued capital gain will remain unchanged at $1,000,000.

Copyright © 2019 The Institute for Advanced Financial Education.

Advantages

The advantages of the criss-cross structure include:

- The simplicity of the structure is easy to explain and understand;
- The deceased shareholder is entitled to capital gains treatment on the disposition of her shares;
- The deceased shareholder may be able to use the capital gains exemption; and,
- The surviving shareholder gets a step-up in her ACB for the shares.

Disadvantages

The disadvantages of the criss-cross structure include:

- The cost of the life insurance premiums is greater than under the following two models because the cost is funded personally in after-tax dollars;
- It is more difficult to police premiums payments, so one shareholder may not be aware that another shareholder has discontinued coverage, which could create financial uncertainty relative to succession plans;
- Changes to the policy could occur without the insured shareholder's permission, again leading to potential uncertainty relative to succession plans; and,
- Management of the strategy increases in complexity as the shareholder structure grows beyond simply two shareholders.

Copyright © 2019 The Institute for Advanced Financial Education.

Promissory Note Method

Under the promissory note method of a buy-sell arrangement, the agreement is between the shareholders, similar to the criss-cross method. If a shareholder passes away prematurely, her estate is obligated to sell the shares held by the deceased shareholder, and the surviving shareholder is obligated to buy the shares held by the deceased shareholder. However, unlike the criss-cross method of structuring a buy-sell arrangement, the life insurance policies on the lives of the shareholders are held and funded by the corporation.

Upon the death of one shareholder, the buy-sell would be completed by the surviving shareholder delivering a promissory note to the estate in consideration of the shares purchased from the estate. Once the surviving shareholder owns all of the shares, she would declare a capital dividend to herself and repay the promissory note that she gave to the estate. The capital dividend is funded by the company's receipt of the life insurance proceeds.

The primary advantage of the promissory note method over the criss-cross method is that the cost of the life insurance is borne by the company.

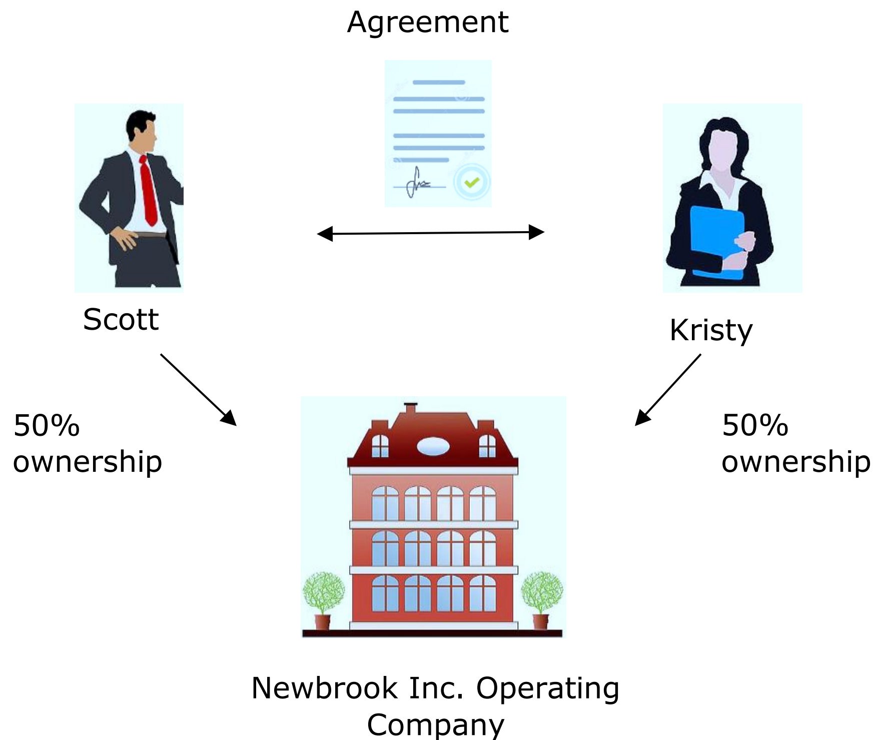
Corporate-Owned Life Insurance

Corporate-owned life insurance is considered to be more efficient than personally owned life insurance. The reason for the enhanced efficiency ties to the fact that life insurance premiums are not tax deductible, so it makes the most sense that premiums are paid by the taxpayer in the lowest tax bracket.

EXAMPLE (CONT'D)

Assume the facts related to Scott and Kristy remain the same, except that the buy-sell arrangement is structured as a promissory note arrangement.

Copyright © 2019 The Institute for Advanced Financial Education.



Newbrook Inc. is the owner of two life insurance policies –one on Scott's life and the other on Kristy's life. Newbrook is the beneficiary under each of these policies.

While there is efficiency in terms of using corporate-owned life insurance relative to the premium payments, there are many other issues to address with respect to decisions related to ownership of the policy. For example, a primary drawback of corporate-owned life insurance is the fact that it exposes policy values to the creditors of the company. Creditor protection can become very critical when one considers that the company has just lost one of its owners/managers and creditors may have a different view of the firm's creditworthiness.

Copyright © 2019 The Institute for Advanced Financial Education.

Income Tax Results

Deemed Disposition

Upon death, a taxpayer is deemed to have disposed of all capital property for proceeds equal to its FMV. Since the shares are subject to a buy-sell arrangement, the value assigned under the agreement will be an indication of the FMV of the shares.

EXAMPLE (CONT'D)

This means upon Scott's death, he will be deemed to have disposed of his shares of Newbrook for proceeds equal to fair market value.

Fair market value	$1,000,000
Scott's ACB	Nominal
Capital gain	$1,000,000
Taxable capital gain	$500,000
Less enhanced capital gains deduction	Unknown

Buying & Selling Shareholder's Shares

The buy-sell arrangement creates an obligation upon the estate to sell the deceased shareholder's shares and on the surviving shareholder to buy the shares.

The estate receives the shares from the deceased and is able to add the capital gain recognized by the deceased to the estate's ACB of the shares. As a result, the estate does not have a capital gain on the disposition of the shares to the surviving shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE (CONT'D)

Upon Scott's death, his estate will receive the shares from him and will add the capital gain he recognized on his final tax return to the estate's ACB for the shares. The disposition of the shares from Scott's estate to Kristy will occur at the current market value of the shares, which is now equal to the estate's ACB.

Proceeds of sale	$1,000,000
Estate's adjusted cost base	$1,000,000
Capital gain	None

Giving a Promissory Note

The surviving shareholder will give a promissory note to the estate in consideration for the purchase of the shares.

EXAMPLE (CONT'D)

Kristy will give a $1,000,000 promissory note to Scott's estate in return for ownership of his shares of Newbrook.

Purchase price for 50% of the shares	$1,000,000
Original cost for original 50% of the shares	Nominal
New adjusted cost base	$1,000,000
Fair market value of the company	$2,000,000
Kristy's accrued capital gain	$1,000,000

Copyright © 2019 The Institute for Advanced Financial Education.

Collecting Life Insurance Proceeds

The surviving shareholder will cause the company to collect the life insurance proceeds.

EXAMPLE (CONT'D)

As owner of a life insurance policy on Scott's life, Newbrook will make a claim to the insurance company upon Scott's death.

Capital Dividend Account

Upon receipt of the life insurance proceeds, the company will credit its capital dividend account and be able to pay a capital dividend to the surviving shareholder. The addition to the capital dividend account is equal to the amount of life insurance proceeds in excess of the ACB in the policy.

EXAMPLE (CONT'D)

Upon the receipt of the insurance proceeds, Newbrook will credit its capital dividend account and subsequently pay a dividend to Kristy, the surviving shareholder, electing as much as possible capital dividend treatment.

Life insurance proceeds received	$1,000,000
ACB of the policy	$25,000
Dividend declared and paid to Kristy	$1,000,000
Elected as a capital dividend	$975,000
Remainder is a taxable dividend	$25,000

Copyright © 2019 The Institute for Advanced Financial Education.

Proceeds of the Capital Dividend

The surviving shareholder will use the proceeds of the capital dividend and repay her promissory note to the estate.

EXAMPLE (CONT'D)

Kristy will use the proceeds from the dividend to repay her promissory note to Scott's estate.

Advantages

The advantages of the promissory note structure include:

- The cost of the life insurance premiums is less than under the criss-cross method because the cost is funded corporately;
- The simplicity of the structure is easy to explain and understand;
- The structure is easier to manage when there are more than two shareholders;
- The deceased shareholder is entitled to capital gains treatment on the disposition of her shares;
- The deceased shareholder may be able to use the capital gains exemption; and,
- The surviving shareholder gets a step up in her ACB.

Disadvantages

The disadvantages of the promissory note structure include:

- The life insurance policy and proceeds could be exposed to creditors of the company;
- Insolvency tests may be required before a dividend can be paid to the surviving shareholder; and,
- The shareholders' agreement will have to specifically exclude the value of the life insurance proceeds from the value of the shares of the company.

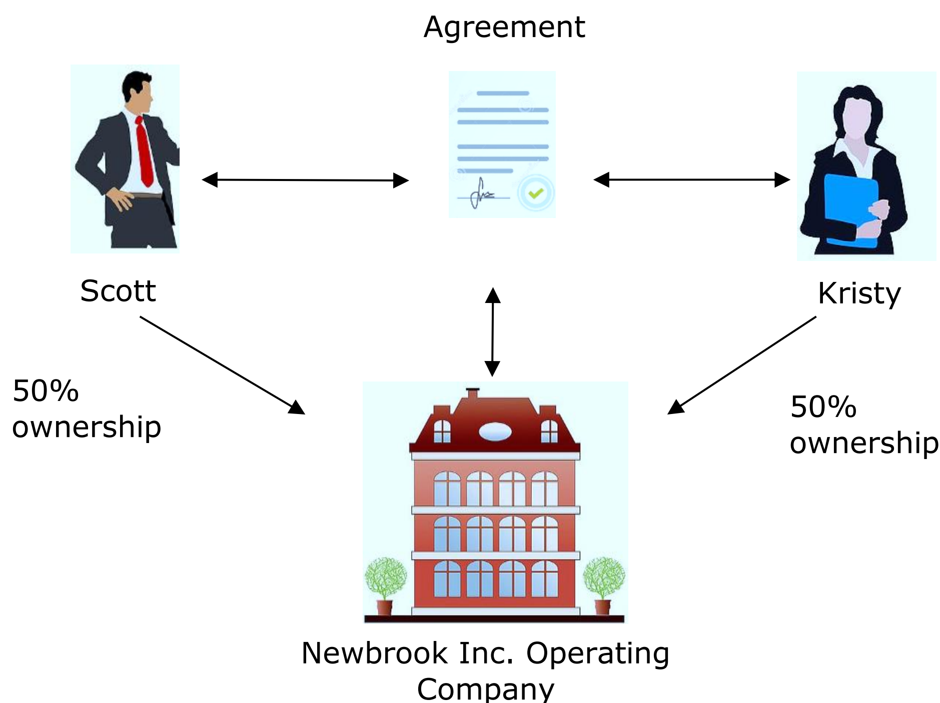
Copyright © 2019 The Institute for Advanced Financial Education.

Redemption Method

Under the redemption method of a buy-sell arrangement, the agreement is between the shareholders and the company. If a shareholder were to pass away prematurely, her estate is obligated to sell the shares held by the deceased shareholder, and the company is obligated to redeem the shares held by the deceased shareholder. The life insurance policies are held and funded by the corporation on the lives of the shareholders.

EXAMPLE (CONT'D)

Assume the facts related to Scott and Kristy remain the same, except that the buy-sell arrangement is structured as a redemption arrangement.



Newbrook Inc. is the owner of two life insurance policies –one on Scott's life and the other on Kristy's life. Newbrook is the beneficiary under each of these policies.

Copyright © 2019 The Institute for Advanced Financial Education.

Income Tax Results

Deemed Disposition

Upon death, a taxpayer is deemed to have disposed of all capital property for proceeds equal to its FMV. Since the shares are subject to a buy-sell arrangement, the value assigned under the agreement will be an indication of the FMV of the shares.

EXAMPLE (CONT'D)

This means upon Scott's death, he will be deemed to have disposed of his shares of Newbrook for proceeds equal to fair market value.

Fair market value	$1,000,000
Scott's ACB	Nominal
Capital gain	$1,000,000
Taxable capital gain	$500,000
Less enhanced capital gains deduction	Unknown

Buying & Selling Shareholder's Shares

The buy-sell arrangement creates an obligation upon the estate to sell the deceased shareholder's shares, and on Newbrook to redeem the shares.

Redemption of the shares is treated as a return of capital and a dividend. A portion of the deemed dividend could be elected as a capital dividend paid by the company to the shareholder.

All, or a portion, of the deemed dividend could be elected as a capital dividend. However, the stop-loss rules introduced in April 1995 restrict the estate's ability to carry losses realized in the estate back to the terminal tax return.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE (CONT'D)

This means upon Scott's death, his shares will be redeemed by Newbrook from his estate for proceeds equal to fair market value.

Proceeds of redemption	$1,000,000
Paid up capital of the shares	Nominal
Deemed Dividend	
Excess of proceeds over paid up capital	
Proceeds of redemption	$1,000,000
Paid up capital of shares	Nominal
Deemed dividend	$1,000,000
Deemed Proceeds	
Proceeds of redemption	$1,000,000
Less: Deemed dividend	$1,000,000
Deemed proceeds of disposition	Nominal

	100% Election	50% Election
Deemed dividend	$1,000,000	$1,000,000
Capital dividend	$1,000,000	$500,000
Taxable dividend	None	$500,000
Deemed proceeds of disposition	None	None
Estate's ACB	$1,000,000	$1,000,000
Capital loss	$1,000,000	$1,000,000

Copyright © 2019 The Institute for Advanced Financial Education.

Reduction for stop loss rules	$500,000	None
Capital loss to be carried back to the terminal tax return	$500,000	$1,000,000
Capital gain as reported on the terminal tax return	$1,000,000	$1,000,000
Capital loss carried back from the estate	$500,000	$1,000,000
Revised capital gain	$500,000	$0
Summary		
Taxable dividend in the estate	$0	$500,000
Revised capital gain	$500,000	$0

This highlights the fact that Scott, as the deceased shareholder, will have an income tax liability under the redemption method of a buy-sell agreement.

Redeeming the Shares

In a sense, the surviving shareholder is not involved in the purchase because it is the company that will redeem the shares from the deceased shareholder's estate.

After the company redeems the shares from the deceased shareholder's estate, the surviving shareholder becomes the 100 percent shareholder of the company. The value of the surviving shareholder's shares will have doubled because he is now the only shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE (CONT'D)

Since the value of the company remains the same and Kristy's shares represent the only outstanding shares of the company, Kristy will experience an increase in her accrued capital gain.

Purchase price for 50% of the shares	$1,000,000
Bump in respect of Scott	$0
Total adjusted cost base	Nominal
Fair market value of the company	$2,000,000
Kristy's accrued capital gain	$2,000,000

Note that Kristy's accrued capital gain doubles under the redemption method of structuring a buy-sell arrangement.

Adjusting the Accrued Capital Gain

The surviving shareholder may be able to adjust her accrued capital gain to the extent that not all of the CDA credit was elected on the redemption of the deceased shareholder's shares.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE (CONT'D)

Kristy can use any remaining credit to reduce her accrued income tax liability. The following charts show the results of two different capital dividend elections on Scott's shares.

	100% Election	50% Election
Deemed dividend	$1,000,000	$1,000,000
Capital dividend elected	$1,000,000	$500,000
Remaining credit	None	$500,000
Capital dividend paid to Kristy	None	$500,000

If the company does not have the cash to pay a capital dividend to Kristy, it could finance the dividend by providing a promissory note to her. The results would be as follows:

	100% Election	50% Election
Value of Newbrook	$2,000,000	$2,000,000
Promissory note	$0	$500,000
Capital dividend paid to Kristy	$2,000,000	$1,500,000

Under the redemption approach, Scott as the deceased shareholder will be exposed to a tax liability on either a $500,000 dividend or $500,000 capital gain. While the tax liability will be lower on the $500,000 capital gain, the cost to lower the tax liability was declaring the entire deemed dividend as a capital dividend.

The cost to Kristy, as the surviving shareholder, of declaring the entire dividend as a capital dividend is a deferred tax liability of $500,000 accrued capital gain.

Copyright © 2019 The Institute for Advanced Financial Education.

Shareholder Consequences

The previous scenario was used to illustrate the tax consequences of the redemption method and highlight the importance of assessing the tax consequences relative to all of the parties involved in a transition.

It should be noted that a redemption style of buy-sell arrangement will change the share interest of the shareholders, and it is important to consider whether or not this might be an issue in each situation.

EXAMPLE

Bill, Bob, and Brent are shareholders of B3 Inc., each owning 40, 40, and 20 shares, respectively, which represent all issued and outstanding shares. If B3 redeems Bill's shares upon his passing, this eliminates his 40 shares resulting in 60 shares outstanding. The chart below shows the shareholdings pre- and post-Bill's death.

	Current Shareholdings (# of shares)	After Bill's Passing (# of shares)
Bill	40	0
Bob	40	40
Brent	20	20
TOTAL	100	60

In this example, no one shareholder controlled the B3. Instead, because of the overall split of shareholdings, Brent's 20 shares provided him with a swing vote in cases where Bill and Bob were to disagree. Subsequent to Bill's passing, Bob's share position provided him with control of B3.

Copyright © 2019 The Institute for Advanced Financial Education.

Advantages

The advantages of the redemption structure include:

- The cost of the life insurance premiums is less than under the criss-cross method because the cost is funded corporately, in before-tax dollars;
- The structure is quite easy to manage when there are more than two shareholders; and,
- The deceased shareholder can lower her income tax liability.

Disadvantages

The disadvantages of the promissory note structure include:

- The life insurance policy and proceeds could be exposed to creditors of the company;
- Insolvency tests may be required before a dividend can be paid to the surviving shareholder;
- The deceased shareholder loses the opportunity to use the capital gains exemption; and,
- The surviving shareholder does not get a step-up in her ACB.

Comparison

There is nothing right or wrong about any of the methods of structuring a buy-sell arrangement. The choice between the alternative methodologies will depend on the facts of the situation and the views of the parties involved as to the amount and timing of the income tax liabilities.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

The following chart summarizes some of the key tax facts that result from the utilization of each of the buy-sell arrangement strategies.

Type of Agreement			
	Criss-Cross	Promissory Note	Redemption
Potential tax exposure for Scott, as the deceased shareholder	$225,000	$225,000	$150,000
Accrued capital gain for Kristy, as surviving shareholder	$1,000,000	$1,000,000	$1,500,000
Ownership of the life insurance policies	Shareholder	Company	Company
Assumptions: 1. The capital gain is taxed at an effective tax rate of 22.5 percent (i.e. 50 percent inclusion rate and 45 percent MTR). 2. A dividend is taxed at an effective tax rate of 30 percent.			

Copyright © 2019 The Institute for Advanced Financial Education.

Hybrid Method

As the name suggests, the hybrid method uses a combination of buy-sell arrangements. The usual combination is a split between the promissory note method and the redemption method.

It is very important to observe the order in which the two methods are applied to a situation. Application in the wrong order could expose the surviving shareholder to litigation from the estate. The proper order is to use the promissory note method before the redemption method because the redemption method reduces the number of outstanding shares that represent the value of the company; the redemption method actually increases the value per share. This means that if the redemption method were applied first, the remaining shares held by the estate would go up in value and result in a greater cost to the surviving shareholder.

Basic Description

Under the hybrid method of a buy-sell arrangement, the agreement is between the shareholders and the company. If a shareholder passes away prematurely, her estate is obligated to sell the shares held by the deceased shareholder and the surviving shareholder is obligated to buy some of the shares held by the deceased shareholder, and the company is obligated to redeem the remaining shares held the deceased shareholder.

The specific allocation of shares to be purchased by the surviving shareholder and shares to be redeemed by the company is determined at the time of death, taking into consideration the facts of the situation. Some of the facts that will be considered include:

- The value of the deceased shareholder's remaining capital gains exemption;
- Any capital loss carry-forwards associated with the deceased shareholder;
- Any other deductions available to the deceased shareholder.

The strategy works towards leaving the estate with a net capital gain (i.e., capital gain less the capital loss carried back from the estate) that is offset with deductions available to the deceased on her terminal tax return.

Copyright © 2019 The Institute for Advanced Financial Education.

Like the promissory note and redemption methods of structuring a buy-sell arrangement, the life insurance policies on the lives of the shareholders are held and funded by the corporation.

Income Tax Results

Deemed Disposition

Upon death, a taxpayer is deemed to have disposed of all capital property for proceeds equal to FMV. Since the shares are subject to a buy-sell arrangement, the value assigned under the agreement will be an indication of the FMV of the shares.

EXAMPLE (CONT'D)

Assume the facts related to Scott and Kristy remain the same, except that the buy-sell arrangement is structured as a hybrid arrangement.

This means upon Scott's death, he will be deemed to have disposed of his shares of Newbrook for proceeds equal to fair market value.

Fair market value	$1,000,000
Deceased shareholder ACB	Nominal
Capital gain	$1,000,000
Taxable capital gain	$500,000

Copyright © 2019 The Institute for Advanced Financial Education.

Buying & Selling Shareholder's Shares

The buy-sell arrangement creates an obligation upon the estate to sell some of the deceased shareholder's shares to the surviving shareholder and then the remaining shares to the company as a redemption of shares.

For example purposes, it will be assumed that the surviving shareholder will purchase 50 percent of the shares and 50 percent will be redeemed by the company.

The estate receives the shares from the deceased and is able to add the capital gain recognized by the deceased to the ACB of the shares. As a result, the estate does not have a capital gain on the disposition of the shares to the surviving shareholder.

EXAMPLE (CONT'D)

Upon Scott's death, his estate will receive the shares from him and will add the capital gain he recognized on his final tax return to the estate's ACB for the shares. The disposition of the shares from Scott's estate to Kristy will occur at the current market value of the shares, which is now equal to the estate's ACB.

Proceeds of disposition (50% of shares)	$500,000
Estate's adjusted cost base	$500,000
Estate's capital gain	None

Copyright © 2019 The Institute for Advanced Financial Education.

Giving a Promissory Note

The surviving shareholder will give a promissory note to the estate in consideration for the purchase of the shares.

EXAMPLE (CONT'D)

Kristy will give a $500,000 promissory note to Scott's estate in return for ownership of his shares of Newbrook.

Original ACB on original shares	Nominal
Purchase price of shares from estate	$500,000
New ACB	$500,000
Value of the company	$2,000,000
Accrued capital gain	$1,500,000

Collecting Life Insurance Proceeds

The surviving shareholder will cause the company to collect the life insurance proceeds.

EXAMPLE (CONT'D)

As owner of a life insurance policy on Scott's life, Newbrook will make a claim to the insurance company upon Scott's death.

Copyright © 2019 The Institute for Advanced Financial Education.

Capital Dividend Account

Upon receipt of the life insurance proceeds, the company will get a credit to its capital dividend account.

EXAMPLE (CONT'D)

Upon the receipt of the insurance proceeds, Newbrook will credit its capital dividend account.

Redeeming the Shares

The buy-sell arrangement creates an obligation upon the estate to sell the remaining shares and on Newbrook to redeem the remaining shares held by the deceased's estate. Newbrook will use $500,000 of the life insurance proceeds to redeem the remaining shares from Scott's estate.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE (CONT'D)

This means upon Scott's death, his remaining shares will be redeemed by Newbrook from his estate for proceeds equal to fair market value.

Proceeds of redemption	$500,000
Paid up capital of the shares	Nominal
Deemed dividend	
Excess of proceeds over PUC	$500,000
Elected as a capital dividend	$250,000
Remainder is a taxable dividend	$250,000
Estimated tax thereon	$75,000
Disposition	
Deemed proceeds	Nominal
Estate's adjusted cost base	$500,000
Capital loss	$500,000
Reduction for stop loss rules	None
Capital loss carried back	$500,000
Revised terminal tax return	
Capital gain as filed	$1,000,000
Capital loss carried back from estate	$500,000
Capital gains exemption	$500,000
Net	$0

Copyright © 2019 The Institute for Advanced Financial Education.

Paying a Capital Dividend

As the 100 percent shareholder, the surviving shareholder will draw the remaining life insurance proceeds out of the company by paying a capital dividend on her shares.

EXAMPLE (CONT'D)

Kristy will use the proceeds from the capital dividend to repay her promissory note to Scott's estate.

Summary

EXAMPLE (CONT'D)

Scott, the deceased shareholder, incurred a net liability for income tax of $75,000 made up of zero from the revised terminal tax return since his executor was able to utilize the remaining capital gains exemption and $75,000 from the estate based on the taxable dividend realized upon the redemption of shares.

Kristy, the surviving shareholder, has a bump to her adjusted case base of $500,000 and is able to draw $250,000 as a capital dividend.

Advantages

The advantages of the hybrid structure include:

- The cost of the life insurance premiums is less than under the criss-cross method because the cost is funded corporately; and,
- The structure creates the opportunity to maximize tax results at the time of each shareholder's death.

Copyright © 2019 The Institute for Advanced Financial Education.

Disadvantages

The disadvantages of the promissory note structure include:

- The life insurance policy and proceeds could be exposed to creditors of the company;
- Insolvency tests may be required before a dividend can be paid to the surviving shareholder; and,
- The shareholders' agreement will have to specifically exclude the value of the life insurance proceeds from the value of the shares of the company.

Spousal Rollover

In most shareholders' agreements, the buy-sell arrangement is obligatory. This means the estate must sell and the surviving shareholder must buy upon the trigger event. In such a situation, the shares cannot pass to the deceased's surviving spouse because the shares cannot vest indefeasibly in the spouse. The surviving spouse has no legal rights with respect to the shares because the surviving shareholder has a right to purchase the shares.

A spousal rollover may be desirable in order to double the capital gains exemption or to avoid the stop-loss rules.

If a spousal rollover is desired, it can be accomplished by structuring the buy-sell arrangement with a put and call option. Under a put and call option, the deceased shareholder bequeaths the shares to the surviving spouse. As specified in the buy-sell agreement, the surviving spouse has a 30-day right to put the shares to the surviving shareholder for purchase or to the company for redemption. At the end of the surviving spouse's 30-day window, the surviving shareholder has a 30-day right to call the shares for purchase by the surviving shareholder and/or redemption by the company.

The primary advantage of being able to utilize the spousal rollover is to avoid the implication of the stop- loss rules under the redemption method of structuring the buy-sell arrangement.

Integrating a spousal rollover into the redemption method of structuring the buy-sell arrangement creates a process that appears as follows:

Copyright © 2019 The Institute for Advanced Financial Education.

1. Upon the death of a shareholder, shares owned by the deceased are transferred to her surviving spouse under the spousal rollover rules.
2. The surviving spouse has 30 days to put the shares to the company for redemption.
3. Upon redeeming the shares, the company elects that the resulting deemed dividend is a capital dividend.
4. The surviving spouse receives the capital dividend, which is tax-free.
5. The surviving spouse does not realize a capital loss, so there is no reduction from the stop-loss rules.

The outcome of this strategy is that the surviving spouse could receive all of the buy-out proceeds without taxation.

Disability

A shareholders' agreement should consider the buy-out of a disabled shareholder. A disabled shareholder may no longer be contributing to the firm, and indeed her needs may be more in line with income and/or capital but without contribution. The company has the expense of replacing the disabled shareholder and may not have sufficient funds to meet the needs of the disabled shareholder.

If the parties agree that the risk of disability should be addressed in the shareholders' agreement such that a disabled shareholder is bought out of the company, then the risk should be insured.

When the risk is to be insured, the definition in the insurance contract should match that in the shareholders' agreement. This will ensure that the funds will be available if a disability were to occur. In addition, the adjudication of whether or not a disability has occurred is left with a third party, the insurance company.

Copyright © 2019 The Institute for Advanced Financial Education.

Structuring the Disability Buy-Sell

In terms of structuring the buy-sell arrangement, the issues for consideration relative to the potential disability of a shareholder are different than those with respect to the risk of death. With disability insurance, as with life insurance, the premiums are not tax deductible. However, while life insurance funds can flow tax-free (i.e., in excess of the ACB of the policy) out of the company, the proceeds of a disability policy cannot be accessed as easily.

One way of structuring the disability buy-sell would be to have each shareholder own her interest in the operating company through a holding company. The operating company would own and pay for a disability policy on each shareholder’s life. If a disability occurs, the operating company would collect the insurance proceeds and use the money to redeem the shares held by the disabled shareholder’s holding company.

Alternatively, each shareholder’s holding company could own the disability insurance on the life of the other person. For example, Ms. A and Ms. B each own 50 percent of Opco through their respective holding companies – Holdco-A and Holdco-B. Holdco-A is the owner of a disability policy on Ms. B while Holdco-B is the owner of a disability policy on Ms. A.

The premiums for the disability policies would be financed by tax-free inter-corporate dividends from the operating company. Upon the occurrence of a disability, the proceeds from the disability policy would be used to buy the shares of the operating company from the disabled shareholder’s holding company. For example, Holdco-A would receive the policy proceeds in the event of Ms. B’s disability and would use the proceeds to buy the shares of Opco owned by Holdco-B.

Planning should incorporate the details of what should happen if a triggering event occurs, and should also address how the outcome is to be financed – often being structured to optimize the results.

Copyright © 2019 The Institute for Advanced Financial Education.

Stop-Loss Rules

The stop-loss rules were introduced in the technical amendment bill of April 1995. The rules reduce an individual's ability to claim a capital loss on shares that have previously received a capital dividend.

The stop-loss formula is as follows:

The reduction of the capital loss is equal to the lesser of:

1. Capital dividends received on the shares; or
2. The amount of the capital loss otherwise determined, minus taxable dividends received on the shares.

In excess of 50 percent of the lesser of:

1. The amount of the loss otherwise determined; and
2. The capital gain reported on the terminal tax return.

The implementation of the stop-loss rules was a significant departure from the taxation system at the time, and a set of criteria was developed such that certain transactions would be grandfathered and remain subject to the old rules.

A situation will be grandfathered if either of the following criteria is met:

1. The disposition occurs pursuant to an agreement in writing that was made before April 27, 1995;
2. The shares were owned by a taxpayer on April 26, 1995, a corporation was a beneficiary of a life insurance policy on April 26, 1995, and it is reasonable to conclude that the life insurance that was in place on April 26, 1995, was to fund a redemption of shares.

Copyright © 2019 The Institute for Advanced Financial Education.

Conclusion

Once the buy-sell piece has been put in place, there is a growing need to tackle the estate planning elements of the owner/manager's estate. This involves drilling down well below the business side of her estate.

Copyright © 2019 The Institute for Advanced Financial Education.

Summary

After completing this module, you should be able to:

- Integrate the income tax techniques used to restructure a corporation;
- Apply the corporate attribution rules and know how to avoid the negative consequences that can arise;
- Understand buy-sell arrangements and align different structures with client-specific needs;
- Reflect the tax consequences arising from a buy-sell arrangement in a client’s estate plan.

Copyright © 2019 The Institute for Advanced Financial Education.

Module 4: Succession Planning for the Disposition of a Business Interest

Learning Objectives

Upon completion of this module, you should be able to:

- Explain, apply and integrate the concept of an estate freeze, identify the implications, and apply alternative strategies to accomplish the client's estate objectives;
- Identify planning issues, analyze the roles of key people and explain alternatives for transitioning a business entity to a subsequent owner;
- Describe and explain the concept of valuation and its implications to shareholders of a private company;
- Identify and evaluate circumstances in which the death of a business owner might give rise to valuation issues in respect of corporate-owned life insurance;
- Explain and apply the CRA's process in respect of valuing corporate-owned insurance and explain the impact of corporate-owned life insurance on the capital gains exemption in a client-specific situation.

Copyright © 2019 The Institute for Advanced Financial Education.

Estate Freeze

An estate freeze is one of the tools in the planner’s toolbox that can be accomplished with a variety of strategies. The objective of an estate freeze is to cause some or all of the future growth on the assets to accrue to another individual. By giving up the future growth on assets, the client has capped his accrued income tax liability associated with those assets. By causing the future growth to accrue to other individuals, the client has begun the process of succession planning and/or estate distribution.

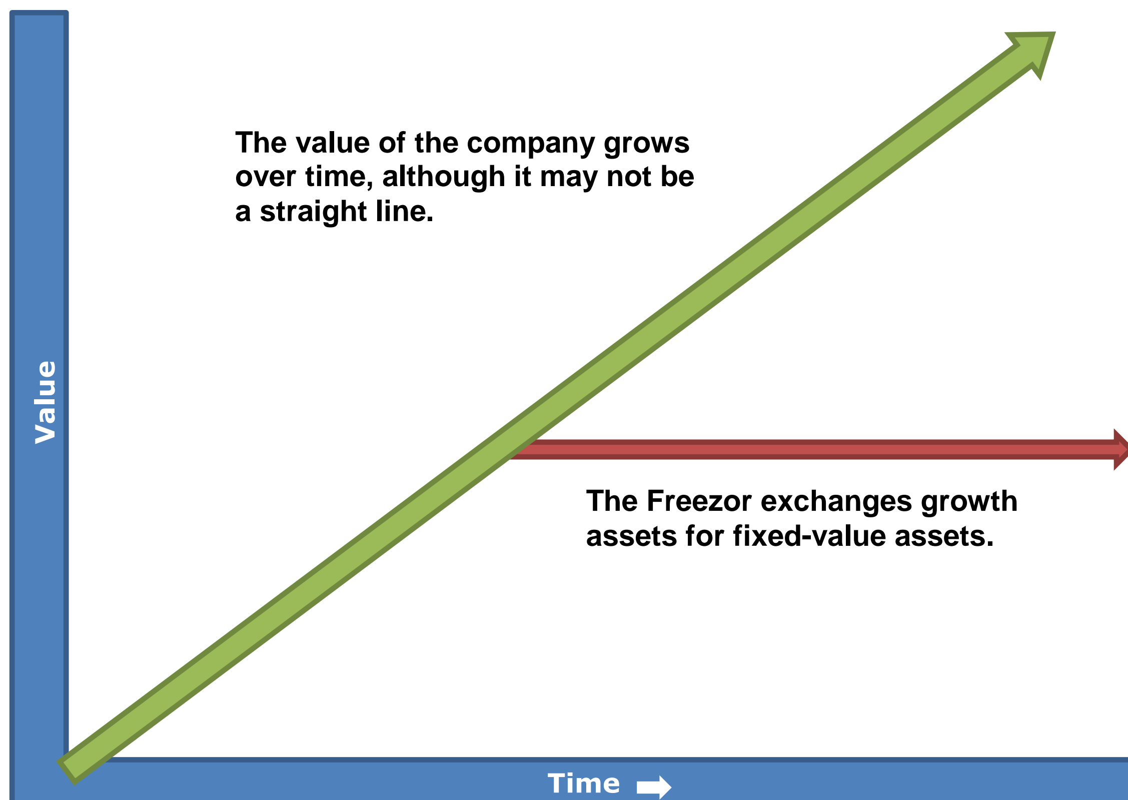
The Concept of an Estate Freeze

Essentially, the freezing of an estate involves replacing growth assets (i.e., common shares) with non-growth assets (i.e., fixed-value preferred shares of a corporation). Simultaneously, a structure is put in place that allows future growth of the asset to be acquired by, or on behalf of, individuals whom the client wishes to benefit (i.e., usually children or grandchildren). It should be noted that it is only the future growth that is given away; the client retains all value accrued to date.

Effectively, when a sole shareholder of a corporation undertakes a complete freeze, the shareholder shifts the full value of the company into fixed-value preferred shares. Given that the entire value of the company is now represented in the preferred shares, new common shares are issued for a nominal amount. The individuals who subscribe for new common shares at a nominal amount will be entitled to future growth. Properly handled, the transfer of future growth, through an estate freeze, is not a taxable event since there is no certainty that such growth will ever occur.

There are many ways of creating an estate freeze, ranging from a direct sale of assets to fairly complex corporate reorganizations. The appropriate vehicle to use will depend, in each case, on the facts of a situation, most notably the nature of the assets to be frozen; the desire of the client (or lack of desire) to continue to control the assets; and, the ages, abilities, and interests of the beneficiaries. As shown in the graph below, the value of the business continues to increase over time, while the “freezor,” who has exchanged his common shares (growth) for fixed-value preferred shares, accepts a capped value.

Copyright © 2019 The Institute for Advanced Financial Education.



Factors of an Estate Freeze

An estate freeze is generally accomplished on a tax-deferred basis where the accrued income tax liability is deferred until the second death of the couple. This is usually an important objective and will dictate the types of strategies to be employed.

A side benefit of estate freezing is that the client may have the opportunity to crystallize his capital gains exemption as part of the transaction. By crystallizing the available capital gains exemption, the client eliminates the risk of not qualifying for the capital gains exemption at a future point in time.

When planning for an estate freeze, care should be taken with respect to the income attribution rules. Depending on the strategy employed, and the types of assets involved, an estate freeze could cause the income attribution rules to apply.

Copyright © 2019 The Institute for Advanced Financial Education.

Choosing an Estate Freeze

Clients should consider an estate freeze for some or all of the following reasons:

- Their current net worth is more than sufficient to meet all of their financial needs for the remainder of their lives;
- They are comfortable with introducing additional owners into the business operations;
- They are comfortable with the knowledge that the future growth of the business could be significantly more than the “frozen” value;
- Other individuals have become involved in the client’s business, and it is important to recognize their involvement by introducing them to an ownership position; for example, this may apply when a child is making a significant contribution to the family business and contributing to the company’s increasing value;
- There is a need to address the growing accrued income tax liability that will arise in the client’s estate; and,
- There is desire to multiply the capital gains exemption across the family members and lower the overall tax liability of selling the business in the future.

Estate freezing is generally not applicable to younger clients because of the quantity of unknown factors in the future that could severely impact their financial security.

Techniques

There are many ways of completing an estate freeze, ranging from a direct sale of assets to an extensive corporate reorganization. The appropriate strategy to use will depend on the facts of the situation and the client’s objectives. The client’s objectives will reflect his desired estate distribution plan, family composition (i.e., age, marriage, ability, interests, etc.), contributors to the company’s value, etc.

Regardless of which strategy is used to affect an asset freeze, the value of the asset is an important consideration. An independent valuation is

Copyright © 2019 The Institute for Advanced Financial Education.

essential to ensure tax compliance and to ensure the long-term estate distribution plan is well-planned.

The parties to an estate freeze include the:

- "Freezor": The person who owns significant assets that are growing in value;
- "Recipients": Persons who will benefit from the freeze because they will be entitled to the future growth component.

The freezor and recipients could be individuals but are not limited to individuals. They could also be a corporation or a trust. As such, the term "person" is used in the above description to align with the ITA's definition of "person," which includes an individual, a corporation, or a trust.

Consider the following examples of freezes:

- A holding company could freeze its interest in an operating company in favour of a trust for the benefit of an employee group;
- A trust could freeze its interest in an operating company in favour of an individual who is a member of a subsequent generation;
- An individual could freeze his interest in a holding company in favour of another holding company that is owned by the next generation.

Sale of Assets

The simplest and most straightforward method of achieving an estate freeze is to sell the growth assets to the intended adult individual recipients. If the recipients are minors, or the recipient group may expand (i.e., all current and future grandchildren) or change in the future (i.e., all grandchildren alive at a certain date in the future), the assets could be sold to a trust for the benefit of the recipient group.

The drawback of this strategy is the immediate realization of any embedded income tax liabilities in the target assets.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

Todd owns an undeveloped piece of land with a value that is expected to increase considerably over the next 10 to 15 years. He bought the land for $100,000 five years ago, and it is now worth $250,000. If Todd sells the land to his son, Kevin, for $250,000, taking back an interest-free note payable over five years, Todd will achieve the following results:

- He will have frozen his asset value at $250,000 (less income taxes), and any future growth will accrue to Kevin.
- He will have a realized capital gain in the year of sale of $150,000, but may be able to claim a reserve in respect of this gain and spread the income tax consequences over five years.
- Upon Todd's passing, the $250,000 note or the payments collected on the note will be part of his estate. For income tax purposes, only the remaining portion of the reserve will be taxed, regardless of the value of the land.

Kevin will have an asset with a cost of $250,000. When the land is sold, any gain will be taxed to Kevin.

This strategy is beneficial when the accrued gain and associated embedded income tax liability is relatively small or the future growth is very significant.

Freezing a Corporation

A freezor could freeze his ownership position in a corporation by utilizing either a section 85 election or a section 86 reorganization of capital. The choice between the two will depend on the facts of the situation and the objectives of the client.

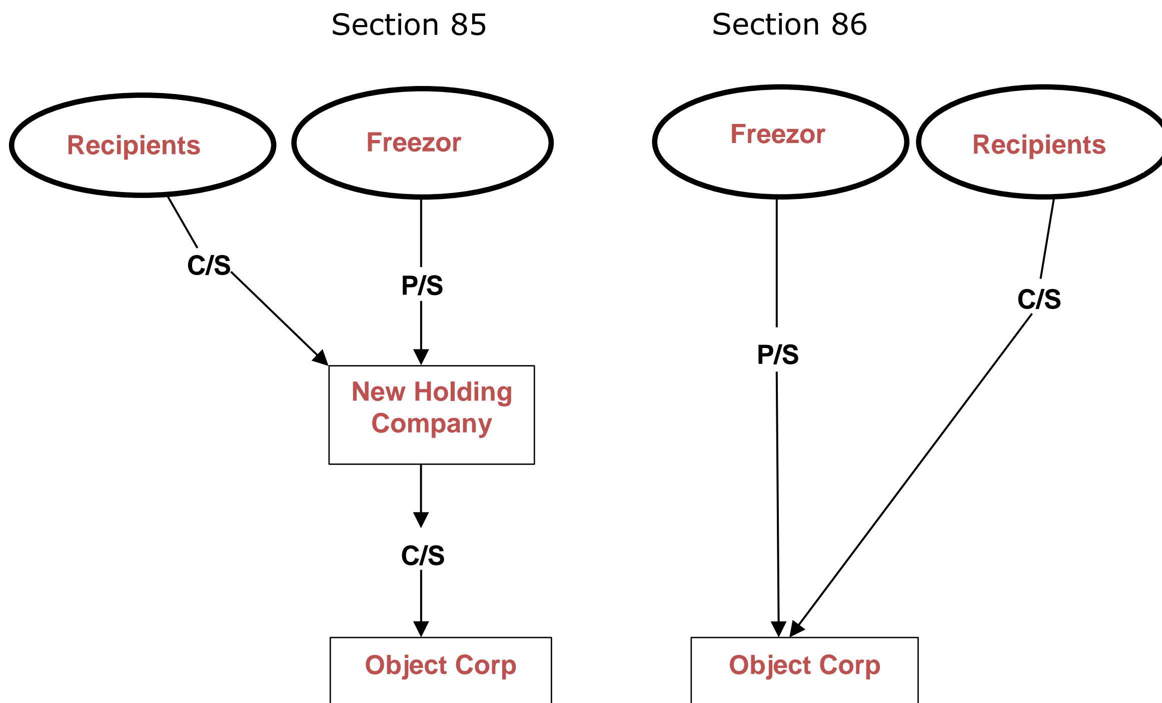
Copyright © 2019 The Institute for Advanced Financial Education.

Section 85

Under a section 85 option, the freezor transfers his shares of the corporation (Opco) to another corporation (Holdco), taking back fixed-value preferred shares of the new corporation (Holdco) in exchange. Both parties to the transaction (freezor and Holdco) would jointly elect under section 85. The person(s) who will assume the future growth position (recipients) would subscribe to common shares of the new corporation.

Section 86

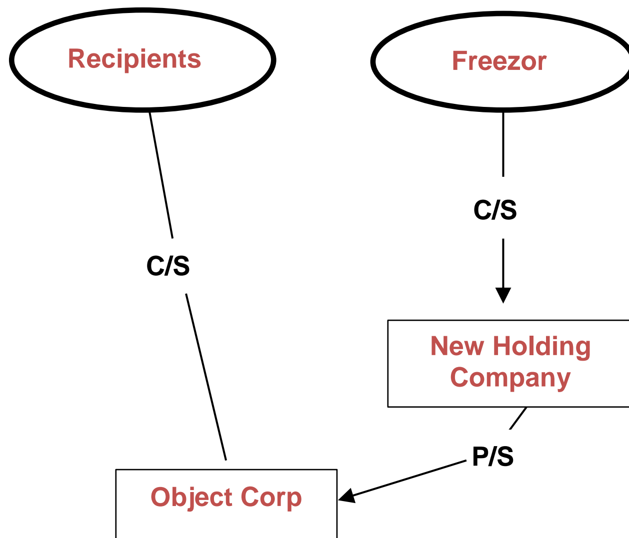
Using a section 86, the freezor exchanges his common shares of the corporation (Opco) for fixed-value preferred shares of the corporation (Opco). The person(s) who will assume the future growth position (recipients) would subscribe to newly issued common shares of Opco.



The flow chart below shows the results of these two transactions.

Alternatively, the freezor may want to be a bit more creative and create a structure as depicted in the following flow chart.

Copyright © 2019 The Institute for Advanced Financial Education.



Using both Sections 85 & 86 for an Estate Freeze

The previous estate freeze structure was accomplished using three steps.

- **Step 1:** The freezor transfers his common shares of Opco to a newly formed corporation (Holdco) and takes back common shares of Holdco as consideration for the exchange. The freezor and Holdco jointly elect under section 85.
- **Step 2:** Holdco uses section 86 to undertake a share-for-share exchange whereby Holdco exchanges the shares it owns in Opco for newly issued fixed-value preferred shares.
- **Step 3:** The person(s) who will assume the future growth position (recipients) subscribe to newly issued common shares of Opco.

The benefit of this structure arises from the sole ownership position that the freezor has assumed in the new holding company. Dividends can be paid from Opco to Holdo, as tax-free inter-corporate dividends (connected corporations). Since the freezor is the sole shareholder of Holdco, decisions about accumulation and distribution of assets in respect of Holdco remain solely in the freezor's hands.

The basic tools are the same and the creativity is based on how best to address the facts of the situation and the objectives of the client. The number of potential structures is limitless and each solution needs to be customized to the needs of the client.

TOSI may apply to dividends paid to the new common shareholders.

Copyright © 2019 The Institute for Advanced Financial Education.

Freezing Personally-Owned Assets

A freezor could freeze his position in personally-held assets by transferring the assets into a corporation and jointly electing, with the corporation, under section 85. In return for the assets transferred to the corporation, the freezor takes back fixed-value preferred shares. The person(s) who will assume the future growth position (recipients) are already common shareholders of the corporation. Real estate holdings are a common type of asset that is often held personally and which can benefit from this type of strategy.

EXAMPLE

Bert and Beth own a significant rental property. They are reviewing their estate plans and were shocked at the amount of the embedding income tax liability associated with this asset. As of today, they were facing an accrued capital gain of $2,000,000 and recapture of capital cost allowance of $500,000. They have decided to fully freeze their position in the asset in favor of their children who are all in their mid-40s and all are happily married with children.

There are many properties involved, and the totals are as follows:

	Total	Land	Building
Fair market value	4,000,000	1,200,000	2,800,000
Adjusted cost base	2,000,000	500,000	1,500,000
Undepreciated capital cost	1,000,000	N/A	1,000,000

Bert and Beth could undertake the following steps to freeze their position in this asset and transfer future growth to their adult children.

- The children incorporate a new company, B2 Limited, subscribing to newly issued common shares for a nominal amount.
- Bert and Beth transfer the land and building to B2. The elected transfer price for the land is $500,000**(the adjusted cost base – tax cost)** and $1,000,000 **(the undepreciated capital cost – tax cost)** for the building.
- In return for the land and building (FMV in), the couple could take back a promissory note (non-share consideration) equal to $1,500,000 (tax cost) and fixed-value preferred shares of B2 worth $2,500,000. The combined FMV of the non-share consideration and B2 shares is $4 million (FMV out).

Copyright © 2019 The Institute for Advanced Financial Education.

Bert and Beth have capped their asset holdings at $4,000,000 and converted the potential recapture of capital cost allowance into a capital gain.

If B2 were to sell the real estate, it would be subject to a capital gain of $2,000,000 and recapture of capital cost allowance of $500,000.

In the Bert and Beth example above, TOSI will likely apply to dividends paid to the children, as they do not fit within the TOSI exceptions.

Refreezing the Freeze

While a first generation may have frozen in favour of a subsequent generation, the continued growth of the assets, over the longer term, can cause a family to decide to refreeze and undertake a subsequent (second or third) freeze. This often occurs in families with large asset holdings that are intended to be an integral part of the family's long-term wealth plan.

An important outcome of a subsequent freeze is the minimization of the cash flow devoted to paying tax as each family member passes away. A freeze can cap a generation's tax liability in respect of their family shareholdings.

EXAMPLE

The Smith family has operated a successful manufacturing company, Smith Inc. (Smith), for over 60 years. The founders, John and Darlene, froze their interest in Smith, at $5,000,000, when they turned age 60 about 15 years ago. Utilizing a section 86 reorganization of capital, the couple froze in favor of their twin children, Jack and Dina.

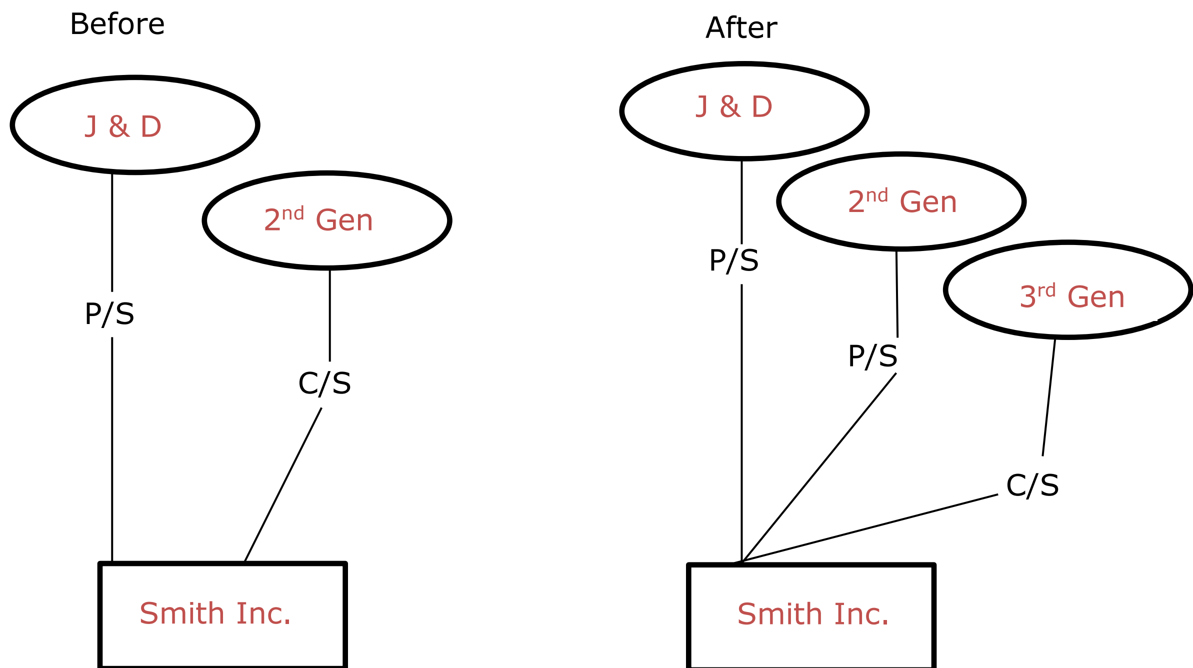
Smith has experienced significant success, and the common shares owned by Jack and Dina are valued at $30,000,000. Jack and Dina, age 50, are each happily married with two children each. The family is starting to introduce the four members of the third generation into senior management roles.

Even though Jack and Dina are very young at age 50, the family (John, Darlene, Jack, and Dina) have decided to freeze Jack and Dina's interest in Smith in favor of the third generation.

Copyright © 2019 The Institute for Advanced Financial Education.

The primary objective is to cap the income tax liability that will arise on the death of Jack and Dina, as they have opted not to roll their shareholdings to their spouses.

The family has decided it will ensure the financial security of each generation.



Family Attributes for a Refreeze

The types of families that consider a refreeze would include some or all of the following attributes:

- The family is going to keep the underlying assets in the family for the long term;
- The individual family members with growth shares have sufficient wealth;
- There is a need to bring the next generation into share ownership; the need could be psychologically or financially motivated.

Copyright © 2019 The Institute for Advanced Financial Education.

Partial Freeze

An estate freeze can be a complete (100 percent) freeze where the client exchanges all of his common shares for fixed-value preferred shares. A client may, however, decide that a partial freeze better suits his objectives. A partial freeze can be accomplished by transferring his common shares for preferred shares and then participating in the purchase of newly issued common shares, along with the intended recipients.

EXAMPLE

Eddie owns EDF Inc., a successful retail firm valued at $2,000,000. His daughter, Jessica, is the firm's COO. Eddie has decided it is time to introduce Jessica into an ownership position given her many years of contributions to the success of EDF.

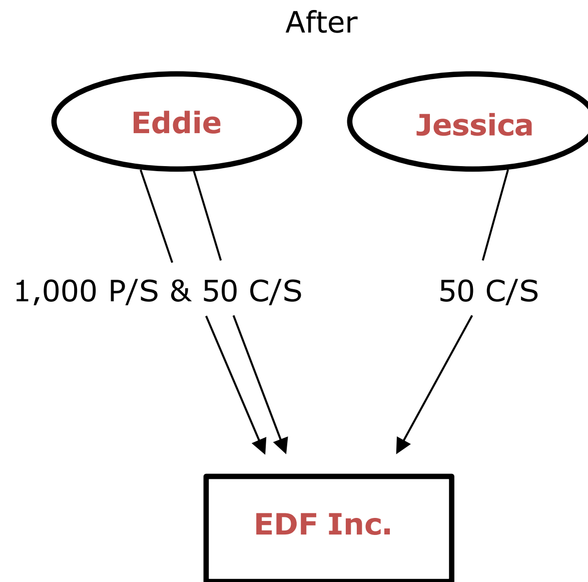
Eddie feels very young and his son, Evan, has only recently started to work at EDF. As such, Eddie has decided to undertake a partial freeze using the following steps.

1. Using a section 86, Eddie exchanges his 100 common shares of EDF (currently valued at $2,000,000) for 1,000 fixed-value preferred shares of EDF.
2. Both Eddie and Jessica subscribe for 50 new common shares of EDF, paying $10 for each share.

At this point Eddie owns 1,000 preferred shares and 50 common shares, while Jessica owns 50 common shares. If Evan evolves into a senior management role at EDF, Eddie is prepared to reorganize again to introduce Evan into share ownership.

The following flow chart shows the structure immediately after the reorganization with Jessica.

Copyright © 2019 The Institute for Advanced Financial Education.



Family Attributes for a Partial Freeze

Families considering a partial estate freeze would have some or all of the following attributes:

- One of the family's planning objectives is to introduce the next generation into share ownership over an extended period and a series of reorganizations;
- It could be part of a buy-out strategy where the freezor introduces the buyer into ownership in preparation for a staged buy-out;
- The freezor wants to continue participating in some of the future growth. The want could be based on financial need or simply a desire to continuously increase his personal wealth.

Systematic Redemption

After the freeze is completed, the freezor may decide to manage his need for income by requesting dividends be paid on the preferred shares. This strategy allows the freezor to retain control, value, and income from the reorganization.

Copyright © 2019 The Institute for Advanced Financial Education.

Alternatively, the freezor could request that some of his fixed-value preferred shares be redeemed annually. A share redemption is taxed like a regular dividend where the deemed dividend arising from the redemption is equal to the excess of the proceeds of redemption over the paid-up capital of the shares. A systematic redemption strategy results in the same tax outcome as a regular dividend strategy; however, as shares are slowly eliminated through the redemption process, the freezor's embedded income tax liability is slowly eroded.

EXAMPLE

Aaron, a widower, owns Opal Inc., a catering company valued at $3,000,000. Aaron froze Opal, using section 86, several years ago when the firm was valued at $2,000,000. He froze in favour of his two adult children, Oliver and Olivia, who are very competent and have assumed much of the day-to-day responsibilities of Opal.

Having just turned age 65, Aaron wants to retire, draw some income from Opal, and plan his estate.

He currently has an embedded capital gain of $2,000,000 ($2,000,000 FMV of his preferred shares, less a nominal ACB), which he can shelter some of with his $866,912 (2019 amount) capital gains exemption. This leaves him with an accrued income tax liability of about $300,000.

Aaron has decided he would like Opal to pay him an annual dividend of about two percent (i.e., $40,000 which is 2 percent of the $2,000,000 value). This amount, together with his RRSP and other savings, will provide Aaron with sufficient retirement income.

Alternatively, Aaron could request that Opal redeem $40,000 of preferred shares annually. Because a share redemption is taxed like a regular dividend, Aaron is indifferent to the annual income tax implications. By systematically redeeming preferred shares, Aaron's accrued income tax liability will diminish by about $10,000 annually (i.e., 50 percent capital gains inclusion rate x $40,000 of shares redeemed x 50 percent tax rate).

Copyright © 2019 The Institute for Advanced Financial Education.

Figure 6

Projection of Tax Liability Arising in Aaron's Estate

Year	FMV of outstanding P/S owned by Aaron	Accrued income tax liability, assuming a fixed $866,912 of capital gains exemption and a 50 percent top marginal tax bracket
After 1 year	$1,960,000	$286,600
After 10 years	$1,600,000	$196,600
After 20 years	$1,200,000	$96,600
After 30 years	$800,000	Zero

Employing a systematic redemption strategy provides Aaron with a regular flow of income during his retirement years, and simultaneously erodes the income tax liability arising in his estate. An element to be aware of when using a redemption strategy is the impact on the shareholder's control of the company. Depending on the share structure (number of votes), there could ultimately be a loss of control when using a redemption strategy. This possibility should be evaluated when assessing the strategy in light of the shareholder's personal objectives.

Copyright © 2019 The Institute for Advanced Financial Education.

Choosing a Systematic Redemption Strategy

A systematic redemption strategy should be considered when some or all of the following elements are present.

- The systematic redemption of shares will not leave the freezor without sufficient income to meet his lifelong needs. As shares are redeemed, there are fewer shares to attract regular dividends.
- The systematic redemption will provide the amount of income needed. Redeeming more shares than needed to generate the required income will create an income tax liability with no benefit.
- The family understands that the dividend tax incurred on the systematic redemption during retirement will reduce the capital gains tax realized in the estate.

Copyright © 2019 The Institute for Advanced Financial Education.

Succession

The topic of succession cannot be packaged into pre-defined strategies; rather, succession involves using the tools and knowledge you have to assist clients in transitioning their business in the most effective way that best meets the client's personal, family, and financial needs.

Soft issues, important to the individual shareholders and their families, will be discussed throughout this chapter. It will become evident that the transition of a business is not simply a black-or-white decision; emotions and personal needs will inevitably need to be considered.

This section of the course has been developed using articles adapted from the Succession Planning series first published in Forum magazine.

Succession: The Casting Call

When providing guidance to clients through significant transitions, it is helpful to understand the roles individuals fulfill in both the family and business. The following discussion[3] *profiles the roles of individuals in a business transition.*

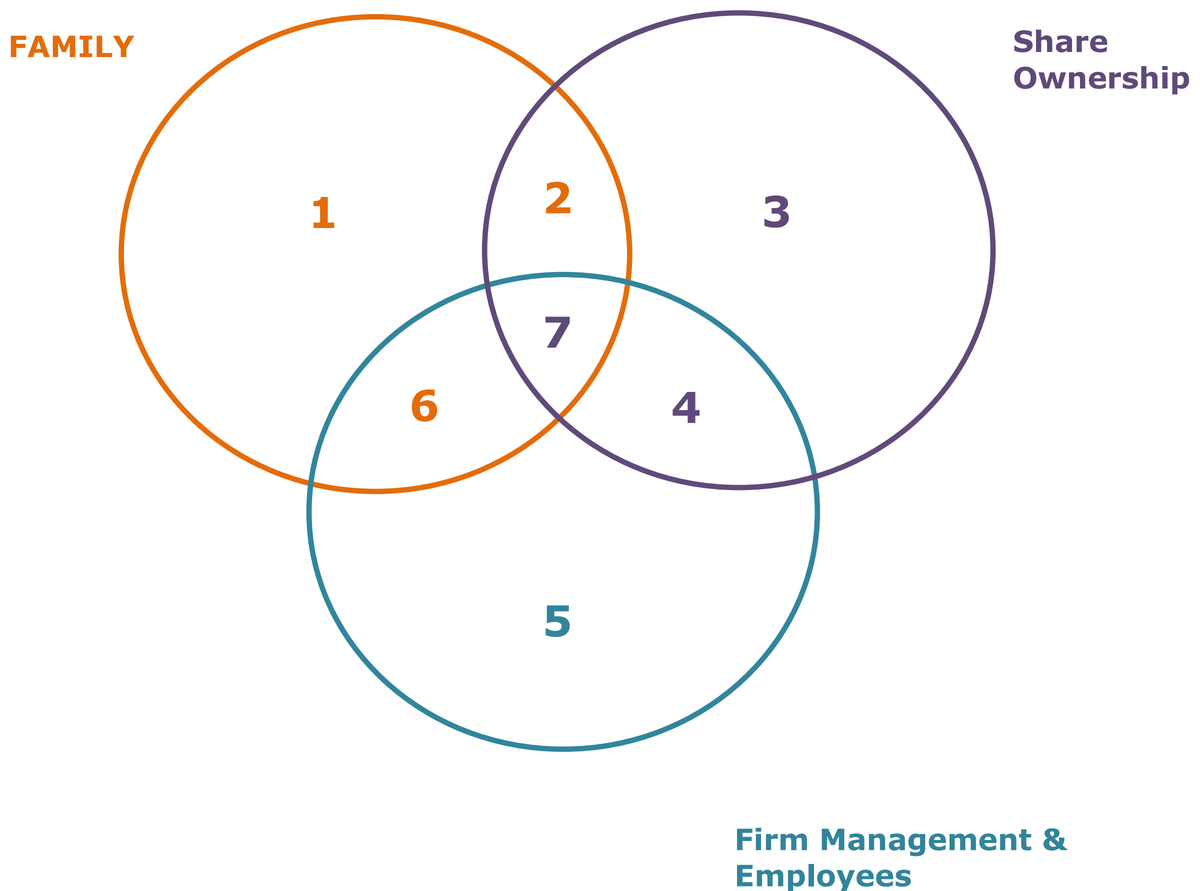
Managing through the succession of a private business operation has a lot of similarities to the performing arts – assembling the players and understanding their talent and combined chemistry can lead to an outstanding performance. However, a miscall in the talent or perhaps overlooking the importance of chemistry can lead to a sub-par performance. In succession planning, understanding who the players are and the role they have relative to the owner-manager will help to ensure a top performance in the succession transition.

3 *Forum*, August 2013, James Kraft & Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

Finding Commonality

All too often, it is easy to forget that while the owner-manager may be the driver of any transition, the key people that surround him or her have expectations. An easy way to classify the cast of players who surround the owner-manager is through a series of three overlapping circles that form a Venn diagram with the owner-manager at the point of intersection. Using the diagram is a simple approach through which to illustrate the relationships in a logical manner.



Copyright © 2019 The Institute for Advanced Financial Education.

Different Interests

Each of the three circles represents a different group of people in relationship to the firm and/or owner – family, shareholders, and management/employees. Using a series of numbers, we can identify each of the possible categories.

At the intersection of all three circles is the owner-manager (segment 7) who is the central figure in the succession process. This individual leads the process and is generally a lead decision-maker throughout.

Family

Segment 1 is the family of the owner-manager who is not directly involved with the business – they do not own shares and do not work in the business. This group could include the business owner's spouse who has remained outside the business operations from a management and ownership perspective, and minor and adult children to the extent a corporate freeze has not put shares in the children's hands or indirectly in a family trust. Other family members who may be classified in this segment could include the parents of the business owner or the spouses of the children.

Individuals in this segment are often dependent on the business owner for financial security, either short- or longer-term, or are adult children with a financial expectation through inheritance. From a succession perspective, this group will often have concerns about the viability of the overall plan to ensure sufficient assets or income.

Management & Employees

Segment 5 represents the management and employees of the business. Purchasers of any business want a strong, ongoing operation, which is typically heavily dependent on the firm's staff. Yet, with a transition, managers and employees will be concerned about their personal financial security, including the prospect of continued employment. Overlooking this group can create unexpected consequences such as the premature departure of key employees or ongoing discontent.

Copyright © 2019 The Institute for Advanced Financial Education.

Through awareness and a supportive approach to communicating with this group, the business owner can allay perceived fears and increase long-term stability, something highly valued by potential purchasers. This can be very important if the sale includes a performance payment after the closing date that is calculated based on future profits or customer retention.

Family as Employees

Segment 6 represents family members as employees, those who hold jobs within the business's operations. Like segment 5, this group is financially dependent on the firm; however, they may be more intimately involved because they may be integral to the transition plan. There could be expectations that this group will ultimately succeed their parent in management and/or ownership roles.

Miscommunication can lead to family disputes and long-term disruption of business operations.

If the business is to transition to the next generation, a process needs to be established to transfer the management and ownership elements. If the business is to succeed to third parties, this segment will need to be part of the discussion in order to maintain harmony and solid business processes on a go-forward basis.

Family as Shareholders

Segment 2 is comprised of family members who are shareholders but who do not work in the company. Individuals may evolve into this role directly because of a corporate freeze or indirectly as beneficiaries of a family trust that owns the growth shares of the business. This segment may not have any short-term expectations of the business owner, but their expectations may change when they become aware their shareholdings may have a significant liquid value.

Those in segment 4 have the dual role of employee and shareholder. Depending upon the value of their shareholdings, it is likely that this group may be concerned about employment prospects and long-term financial security. Open communication will help to maintain their support.

Copyright © 2019 The Institute for Advanced Financial Education.

Conclusion

Succession planning cannot be done in isolation. Understanding each of the players, their interests, and the chemistry they may add to the process is essential to minimize the potential conflict and to set the stage for a successful transition.

Business Transfer: Making Decisions, Outcomes & Risks More Manageable

The generational transfer of business operations is no longer viewed as a defined point in time, but rather is much more focused on factors that are highly customized to the individual entrepreneur. The following discussion[4] looks at making decisions, outcomes, and risks more manageable.

Popular literature from the 1990s emphasized the potential mega-dollar transfer arising from the impending intergenerational handover of the family business. The movement of aging boomers through the workforce and the potential of an abrupt stop as the boomer bulge reached the magic retirement age of 65 were primary assumptions about the shift of wealth between generations on a predetermined schedule.

Changes in Society

While the transfer of business operations is moving along nicely, Canadian society has not experienced the theoretical financial transfer in the magnitude that was predicted. Why?

- **Age 65 is the new age 50**. Boomers are the generation that changed Canadian society. They are young at heart and enjoy a much longer life expectancy than their parents' generation. Age 65 no longer represents a magical retirement date.
- **Changing financial landscape**. Market turmoil has usurped traditional fiscal norms that boomers once relied on. The choice to work longer is helping some boomers to insulate their savings and reduce longer-term financial risk.
- **Succession sounds like funeral planning**. Entrepreneurs are inundated with material and advice about succession planning but not

4 Forum, March 2014, James Kraft & Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

enough about "what's in it for them." To be appealing, succession planning has to be re-framed so it resonates with the entrepreneur whose life currently revolves around business operations.

- **Too busy having fun!** There is a group of entrepreneurs who are busy having fun wheeling and dealing in their business life. This group gathers energy from the business and are not ready to walk away

The generational transfer of business operations is no longer viewed as a defined point in time, but rather is much more focused on factors that are highly customized to the individual entrepreneur. Still, there are common issues that need to be considered in any succession plan – estate liquidity, fairness among the beneficiaries, and a shareholder agreement. Life insurance is an important tool that can make decisions, outcomes, and risks a little easier to manage when dealing with these issues.

Estate Liquidity

Estate liquidity is a key consideration. Without sufficient liquid resources to fund last expenses, outstanding debts, and the final income tax liability, an executor will be faced with selling assets or borrowing funds. The financial drain associated with income taxes is often overlooked by entrepreneurs. The value of the business creates a tax liability at the time of death that needs to be carefully anticipated. While a business may have a high value, that value has a tax cost and, without sufficient liquid resources, the executor could be faced with unpopular choices.

Selling assets, particularly if they are not part of the original plan, can add costs such as a fee for arranging the sale and discounts on the selling price depending on the sense of urgency. A sale could involve a piece of real estate or perhaps the business assets that the entrepreneur hoped to transition based on testamentary wishes. Lack of liquidity can mean tough choices by the executor.

Borrowing can be equally unattractive. Any borrowed funds have to be secured and paid back with interest, which typically is not tax deductible. The loss of value from anticipated assets changes the expected outcome.

Copyright © 2019 The Institute for Advanced Financial Education.

Perceived Fairness

A common goal of many entrepreneurs is to ensure beneficiaries are treated fairly, helping maintain family harmony. The concept of fairness should not be presumed as synonymous with the term equal.

Consider the following scenario. An investment portfolio can be invested by a third-party to produce investment income or support a systematic withdrawal program. A business, on the other hand, must be carefully managed and constantly monitored. Even then, a profit cannot be guaranteed because of business risks. The beneficiary of business shares will often contribute personal energy in order for the business to continue. A $10 million investment portfolio is not necessarily equal to a $10 million private business operation given the risks and potential contributions required by the beneficiaries to maintain value.

Ideally, the issue of fair and equal should not be contemplated in isolation; rather, open family discussions can help establish parameters that beneficiaries feel are equitable and that the entrepreneur is happy with. Open dialogue helps with understanding the “why” behind the plan and allows the entrepreneur to address concerns.

Shareholders’ Agreements

Shareholders’ agreements detail how specific issues are to be dealt with. These agreements aid in mitigating disagreements because they often provide resolution to issues that the parties have already considered and addressed. When family members are involved, one of the most valuable items within a shareholders’ agreement is the buy-sell provision. The agreement provides guidance on inevitable issues such as: Can and how does a family member exit ownership? How are shares disposed of? How is price determined? Can a family member bequeath the shares to a surviving spouse? Can shares be transferred to non-family members? What are the rights of the surviving spouse?

Copyright © 2019 The Institute for Advanced Financial Education.

Life Insurance for Risk Management

A life insurance program will not solve the issues in a client's succession plan, but it may be the most attractive alternative in the choice of strategies available when faced with decisions, risks, and a choice of outcomes.

- Life insurance provides liquidity to an estate at a time when cash flow needs become critical. It can "fill the hole," ensuring the intended outcomes.
- Life insurance is a financial asset that can integrate with other resources to address fair and equal discussion. While the value of business assets may be lopsided, adding insurance can even the bequests.
- And finally, life insurance can be used as the funding vehicle to a family's shareholders' agreement, making it easier to address the tough questions.

To Sell or Not to Sell – The Age-Old Question

The succession of any business requires the current shareholders to make important decisions. The following discussion[5] *looks at the issue of an outright sale of a family business relative to an estate freeze where the parent transfers future growth of the business to the child.*

Succession of a family-owned business can be very satisfying. The parent experiences a feeling of fulfillment knowing that a child is advancing in a great career, as well as the realization that the parent or grandparent's carefully crafted business will evolve into a new family generation. Equally important is the hope that equity from the business will provide the necessary personal retirement income. From the child's point of view, it can be an opportunity to gain an immediate foothold in a viable business enterprise, without the challenges often faced by new entrepreneurs throughout the start-up years.

But if family succession is in the cards, should the child buy the business from the parent, or should the parent freeze his interest and allow the child to buy new common shares for a nominal price? The outright purchase could be for cash, financed with a bank loan, or financed by the parent with a vendor take-back.

5 Forum, September 2012, James Kraft & Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

Outright Sale

Succession through an outright sale allows the parent to realize the value of the business equity and to subsequently invest the capital in a portfolio of investment assets that reflects his retirement profile. The family benefits because it creates perfect equity amongst the children; one child does not gain a perceived financial advantage from the parent. The child may benefit psychologically knowing he has outright ownership without the parent's financial involvement. This can be especially beneficial when family harmony is an overarching objective.

EXAMPLE

If the business is valued at $2,000,000, and the child could arrange a four percent bank loan with repayment over five years, the monthly payment is $36,833. The parent would be entitled to the same monthly payment if he stood in place of the bank and did a vendor take-back. Alternatively, the parent could reduce the interest rate to the current prescribed rate (two percent) and reduce the monthly payments to $35,056.

The government benefits from an outright sale because the parent pays immediate tax on the disposition of the business while the child is subject to tax on the income flow from the business that is needed to meet the payment schedule.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE

The parent would net about $1,717,000 after taxes, assuming that the full $866,912 capital gains exemption (2019 amount) is available and a 50 percent marginal income tax rate.

The child, on the other hand, needs to generate $34,194 per month in after-tax personal income in order to make the monthly payments to the parent (average monthly amounts would be $33,333 principle and $1,722 tax-deductible interest). This translates into monthly corporate profit of $68,388 devoted directly to the buy-out of the practice (assuming the child is in the 50 percent tax bracket). Over five years, $4,103,300 of pre-tax profits is needed to allow the selling parent to net $1,717,000. The net economic effect of this transaction is a tax rate of 58 percent, even with the capital gains exemption considered.

Alternatively, the child might consider creating a new company through which he might purchase the current company from the parent, in the hope of using less-expensive corporate after-tax cash flow to fund the purchase. However, the ITA contains an anti-avoidance provision, section 84.1, which would convert the parent's capital gain into a taxable dividend eliminating the opportunity to utilize the enhanced capital gains exemption. This implication is often missed in the planning for an outright sale and requires professional advice for structuring an indirect sale in order to avoid double-taxation.

Freeze Strategy

Succession, through an estate freeze strategy, involves the parent capping his equity position in the business by exchanging the common shares for fixed-value preferred shares. A dividend or redemption strategy could provide ongoing cash flow to the parent. This approach allows the succeeding child to achieve an ownership position with a minimal immediate financial commitment. The freeze strategy allows the parent to defer income taxes on the disposition and preserve more capital that could attract a reasonable dividend through the operating company. The child's obligation is to create sufficient business income to fund the ongoing dividend

Copyright © 2019 The Institute for Advanced Financial Education.

commitment. From a family perspective, the issue of harmony and financial favouritism can be a drawback.

Process for Evaluation

Financial security and family harmony are pivotal. Protecting the equity value of the business can be essential to the parent's financial security to ensure uninterrupted retirement income. The trade-off becomes investing after-tax proceeds from an outright sale compared with an annual dividend via the preferred shares. In either case, a strong business plan will ensure that the parent and child's visions remain viable.

Conclusion

Family harmony can be overarching as parents strive to find the balance between fair and equal, while ensuring their own financial security. At the initial decision point – sale or freeze – and the eventual distribution of the estate, perceived fairness amongst children will create everlasting impressions.

Family Transition by Chance, Choice or Necessity?

The transition of a privately-owned business is a good example of where making a well-informed choice can lead to the optimal outcome for everyone involved. The following discussion[6] opines on the concept of managing roles and expectations in a family business setting in order to optimize transitions.

As a privately-owned business progresses through its life cycle, so too does the owner of the firm. It becomes inevitable that the shareholder will reach a point when decisions about the future of the business will need to be made – either by chance, choice, or necessity. With any decision, the best outcome typically occurs when decisions are made by choice.

6 Forum, March 2013, James Kraft & Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

The transition of a privately-owned business is a good example, where making a well-informed choice can lead to the optimal outcome for everyone involved. The founder's retirement income and magnitude of legacy are directly attributable to the issue of chance, choice, or necessity.

Heir Apparent

While a firm's founder may take great pride when introducing family members to the business, this momentum can create circumstances where succession becomes assumed. Everyone begins to view the children of the business owner as the heir apparent. The children work in the business and are promoted up through the ranks because they are related to the owner. Passing the business on to the children may not be wrong, but it might not be right if one wants to optimize the outcome, including family harmony.

Family as Employees

Clear separation between share ownership and management of the firm is an essential consideration when maximizing value in a succession plan. As such, when family members are welcomed into the business, they should be assessed based on skills and attributes rather than relationship to the owner.

Copyright © 2019 The Institute for Advanced Financial Education.

Managing Value & Expectations

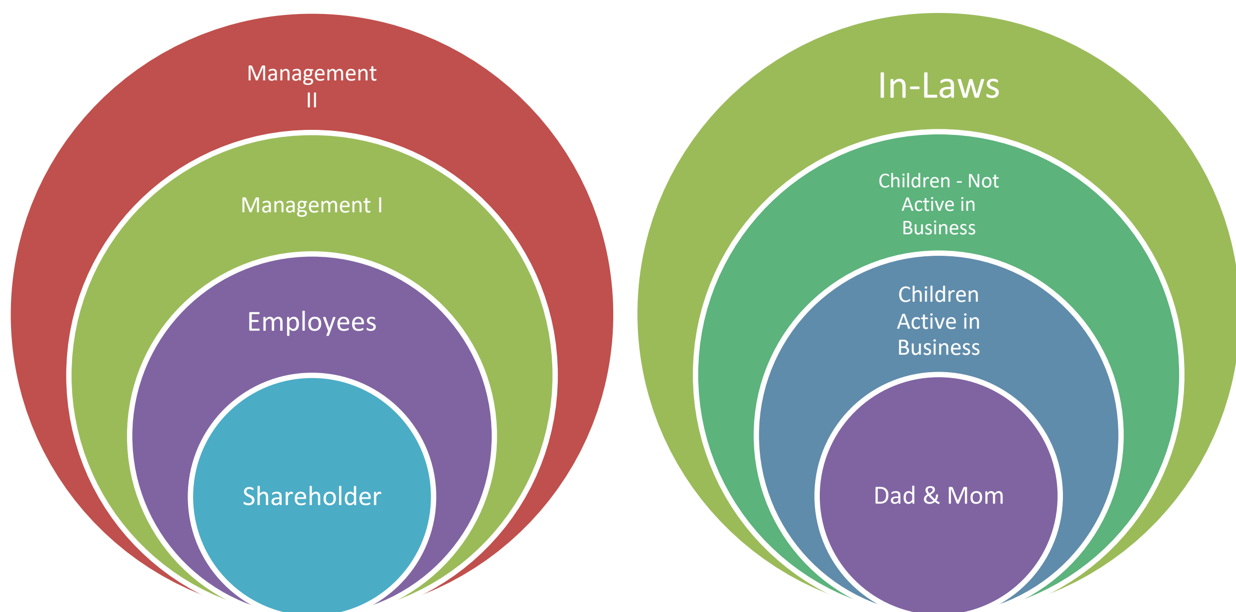
Segmenting those involved with the business into unique categories sets the stage for maximizing long-term value. It helps ensure valued employees do not become disenchanted because of nepotism and creditors do not become uneasy with an impending change. Family members understand they will be evaluated on skills and attributes, reducing unrealistic expectations.

Segmenting and recognizing roles in a family business

1. Share ownership
2. Employee
3. Management I – Junior, overseeing day-to-day operations
4. Management II – Senior, impacting firm's strategic direction

Family Relationships

The theme of family relationships, which often has emotional ties, is one that the business owner will wrestle with when setting personal objectives in respect of any succession plan. In order to optimize the strategic outcome, it is best to evaluate family issues separate from the business itself.



Copyright © 2019 The Institute for Advanced Financial Education.

Presuming a family succession may not be the best decision for the family as a whole, an important step is a skill-match to evaluate essential skills and abilities relative to roles in the firm. In a way, this step is undertaken by every business as it prepares a business plan that addresses the firm's strategic future. In the assessment stage, the founder determines the value-added he or she brings to the business as an employee, manager, and shareholder. This is compared with the subsequent generation's ability to fulfill critical functions left by the departing founder. All is not lost if the skill set of the second generation does not fit the exact skill gap that arises; this may be easily addressed by hiring employees with a targeted set of skills. Undertaking a skill-match helps ensure that future decisions meet the long-term business needs.

Transparency Adds Value

Transparency in the evaluation of strengths and weaknesses increases the value of the process. For example, the issue of sibling rivalry that impacts day-to-day operations is a real business issue but could be inadvertently classified as a family concern. Openness is essential. Evaluating each employee allows family members to clearly see the training requirements important to a smooth transition. When there are skills gaps that cannot be addressed through training or education, two possibilities arise – hire to fill the gaps or consider selling the business.

Third-Party Option

The choice between a family succession and selling the business to a third party should be made in a logical and clear-minded fashion. An issue the founder needs to consider is the potential for family conflict. When conflict may arise, it is often easiest to avoid addressing succession and leave the long-term outcome to chance or necessity.

Copyright © 2019 The Institute for Advanced Financial Education.

Risk Increases Without a Plan

A succession left to chance may occur when the owner opts not to address the long-term needs of the business and relies on the organization's existing strength without evaluating what this might mean. The onset of illness or the founder's inability to lead the organization can leave the firm's future to chance.

Alternatively, a succession outcome driven by necessity may arise when the founder opts not to address the future, and family members active in the business opt to pursue other interests because they feel unfulfilled or become unsure how they fit in the longer term.

Conclusion

Transitioning business operations to a third-party should not be viewed as a failure but as a mark of success, when the decision arises by choice. Ultimately, this can reduce the longer-term financial risk and set the stage for family harmony because the successive generation is no longer responsible as caretaker of the family business. Retirement income and the founder's legacy can be maximized when the transition occurs by choice rather than chance or necessity.

Succession Planning: Let's Make a Deal

While two parties may be interested in striking a deal to transition a private corporation from the vendor to the purchaser, the negotiation process should recognize the differing priorities of the parties involved.

The following discussion[7] highlights important considerations to each of the vendor and purchaser in arriving at an agreeable price.

7 Forum, September 2014, James Kraft & Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

The ownership of every private company transitions at some point in time. Negotiating the optimal outcome requires the parties involved to make decisions about the price and structure in order to affect the final sale. The vendor's role is to present the business as an attractive package, while the purchaser's role is to evaluate the package. The vendor and purchaser will both have a price in mind, and finding the common crossover point is the art of negotiation.

Price Depends on Structure

The price of the package is not always an obvious hard-coded number. The package will, no doubt, involve a direct monetary transfer; however, in addition, there can be intrinsic values that form an important part of the package. The total value negotiated will depend highly on how the deal is structured.

Two mainstream structures involve the sale of business assets (asset sale) and the sale of the corporation as a whole through the transfer of shares (share sale). Because these two packages drive out significantly different income tax consequences, it is important that each of the incumbent parties understands the financial implications for the other. A strong negotiating position depends on understanding the value proposition for the party across the table.

Role Preferences

The typical vendor prefers the sale of shares because of the favourable income tax consequences – a capital gain where only one half is taxable and the potential for using the capital gains exemption.

The typical buyer favours an asset sale for several reasons. The purchaser's tax outcome is enhanced because the amount paid for each asset establishes a new cost base against which CCA can be claimed. The purchaser avoids the assumption of unforeseen liabilities because only the selected assets transfer. Tax reassessments and product liability claims, along with employment and severance obligations, are examples of potential

Copyright © 2019 The Institute for Advanced Financial Education.

obligations that remain with the vendor. The opportunity to cherry-pick the most favorable assets that best integrate with the purchaser's operations helps to optimize the financial outcome for the buyer.

EXAMPLE

Mr. A owns 100 percent of Aco and his Aco shares qualify for the capital gains exemption. Any proceeds from a sale would be taxed at his marginal tax rate of 50 percent.

Mr. A's accountants resourced a certified business valuator who ascertained that the value of goodwill in respect of the business is about $1,100,000 and the value of the company shares would be in the range of $2,800,000 to $3,300,000.

The big operating assets and liabilities inside of Aco are as follows:

	Undepreciated Capital Cost	Adjusted Cost Base	Fair Market Value
Equipment	800,000	2,200,000	1,000,000
Building	700,000	800,000	1,200,000
Land	n/a	500,000	900,000
Mortgage			600,000

Share Sale & Asset Sale

Share Sale

EXAMPLE (continued)

A share sale would net Mr. A somewhere between $2,100,000 and $2,691,700.

Copyright © 2019 The Institute for Advanced Financial Education.

Asset Sale

An asset sale is more complex. The corporation must first sell the assets, repay corporate debt and pay the final income tax liability before being able to wind-up the corporation and make a distribution of the net proceeds to the shareholder.

EXAMPLE

The company realizes recaptured CCA on the equipment and building, capital gains on the building and land, as well as active business income on the sale of the goodwill. Aco has about $3,080,000 after allowing for income taxes and the repayment of the outstanding mortgage. Of the $3,080,000 in net proceeds, $950,000 is available as a capital dividend, while the remaining $2,421,000 is paid as a non-eligible taxable dividend. Ultimately, Mr. A nets about $2,281,700 from an asset sale.

From Mr. A's point of view, the two packages — share versus asset — produce somewhat similar after-tax amounts. It is important to understand the inherent issues of each strategy that reach beyond the dollars transferred and which impact Mr. A's position when negotiating

In both a share and an asset sale, the purchaser will often insist upon a non-competition agreement, particularly if the sale involves goodwill. The terms of these agreements can impact the negotiated price and will be heavily dependent on the seller's future interests. Two major elements of the agreement are often the length of time during which the seller cannot compete and the geography to which the restrictions apply. There can be tax consequences associated with a non-competition agreement that also need to be factored into the analysis.

Copyright © 2019 The Institute for Advanced Financial Education.

Conclusion

Negotiating involves knowing the other party's financial position, including the impact of the tax consequences that apply. The example above looked at basic structures, but alternative hybrid models can also be used to achieve more desirable results depending upon the parties' interests. The art of negotiation means reaching a win-win position for everyone involved.

Case Study: Business Emergencies can be Planned For

All too often business owners put off dealing with issues because there is a sense that "bad things only happen to others." Unfortunately, this type of thinking is naïve, as unforeseen circumstances can hit any business at any time – regardless of how long the business has been in existence. The following discussion[8] looks at the issue of planning for emergencies, highlighting differing needs and priorities of individual shareholders at different stages of the business cycle.

Business owners typically know the importance of having an emergency plan in place, but often struggle to perfect the timing. All too often, something more important precludes the business owner from undertaking important actions that could preserve long-term value.

When the Unexpected Happens

Consider the case of Sam, who operates a dry-cleaning business. One night, while walking home from the store, Sam is hit by a car as he crosses the street. Emergency crews respond quickly and while Sam spends two weeks in the hospital, his prognosis is encouraging.

Unfortunately, Sam's business may not be so lucky. The store remained locked for two weeks, as every one of his customers stopped by to pick up or drop off dry cleaning. None of those customers were happy about the situation and many moved on.

---

8 *Forum*, March 2015, James Kraft & Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

While Sam’s story is about a short-term absence from a simple business, the same issues arise in larger business operations and the seriousness of the absence can be compounded. Banking, payroll, suppliers, customer relationships – simple day-to-day tasks can quickly become a gap eroding years of goodwill. With no plan in place to guide the decision-making during the first phase of an absence, the financial loss can be immediate and sustained.

A simple starting point is developing a contingency plan that outlines what needs to be done and by whom should the business owner be indisposed for a short period of time. From the contingency plan, an exit strategy can be developed for the medium term or should the owner be permanently separated from his role in the business.

We typically think of emergencies as situations like Sam’s where he is indisposed because of a low- probability misfortune. There are many more situations that could divert the business owner’s attention and most occur without advance notice or time to plan. Examples include:

- An unexpected health issue resulting in a short-term disability;
- Longer-term health issues where today’s medical advances mean much greater odds of making a full recovery;
- A marital or relationship breakdown;
- Illness or death of a close family member;
- Premature death of the business owner.

The best time to plant a tree is 20 years ago; the second-best time is today. Similarly, regardless of the business owner’s age or stage of life cycle in which the business is at, a contingency plan is essential to address the owner and business’ needs.

Copyright © 2019 The Institute for Advanced Financial Education.

Start-Up Phase

The **start-up phase** of the business cycle is often characterized by a significant investment of capital, time, and attention from the business owner and very little revenue.

- A young single individual is generally worried about preserving the asset value of the business and ensuring business liabilities are considered in his plan.
- A mid-life individual typically is concerned about protecting family from a financial crisis should he be away from the business, as well as the longer-term impact on his retirement.
- Business liabilities are important to consider in the plan because the assets of the business will probably be insufficient to cover repayment and personal guarantees are often in place for business debt.

Growth Phase

The growth phase of the business is usually characterized by a big investment in financing accounts receivables and inventory. The owner is often delegating a significant amount of day-to-day responsibilities to the management team.

- A business owner who is married with children worries about retaining the value of the business and ensuring that creditors do not bankrupt the business.
- An individual nearing retirement has concerns about how the financial demands of the business will impact retirement plans. Ensuring adequate financial diversification, including accumulation of non-business investments can lower the longer-term financial risk.

Copyright © 2019 The Institute for Advanced Financial Education.

Maturity Phase

The **maturity phase** of the business cycle is usually characterized by stabilized revenues, increased attention to expense management, and higher levels of delegation from the owner to the management team.

- One of the key elements to any plan is to consider those strategies that can preserve the value of the business against the sudden loss of the owner's personal contribution.
- A younger entrepreneur will have time to recover, but preserving business value should still rank high in the plans.
- A mid-life owner will need to ensure his long-term financial goals (such as retirement or education funding) are protected.

Decline Phase

The decline phase of the business cycle is usually characterized by increased competition, customers moving on to newer technology or product advancements, and decreased demand for the product.

- Planning in this phase should focus on value retention and liquidation in order to preserve and capture the value that might remain in the business.

Contingency Planning

Contingency planning for the client under any scenarios could involve some or all of the following strategies:

- **Communication strategies:** A contingency plan should include clear and transparent communication strategies to address the needs of key customers, key suppliers, employees, banks, and creditors.
- **Life and/or critical illness insurance:** Insurance coverage is a valuable resource to reimburse for expenses incurred on the loss of a key executive (business owner), to provide cash for debt repayment and avoid a credit recall, and to fund the buy-sell of shares.

Copyright © 2019 The Institute for Advanced Financial Education.

- **Shareholder agreement:** When there is more than one shareholder there should be adequate provisions in the shareholders' agreement that deal clearly with potential contingency needs.
- **Support team:** There should be a strong management team as well as a professional advisory team that understands their roles in the event of a contingency need.
- **Financial resources:** The plan should address alternative sources of capital (such as equity funds or alternative lenders) in order to fill gaps in capital structuring to address emergency situations.

It is important that business owners know how their business will continue in the event of an emergency.

Copyright © 2019 The Institute for Advanced Financial Education.

Valuation of a Corporation

This section will provide a variety of information about valuation and how it is used in a shareholders' agreement.

- What is fair market value?
- What are the primary methodologies used by certified business valuators?
- How is price determined in a shareholders' agreement?
- How shareholder relationships may impact how the CRA views the price set in the shareholders' agreement.
- Price adjustment clauses.

Transactions

When undertaking a transaction, everyone wants to make the best deal possible. In any transaction, it takes two parties, and each party has his or her own objectives.

EXAMPLE

Assume, for example, Bob wants to purchase Targetco Inc., so he approaches Sally, who is the firm's current owner. Bob has a price in mind that he is willing to pay to Sally for her Targetco shares. Similarly, Sally has a price in mind at which she is willing to sell the Targetco shares. Through a series of negotiations, Bob and Sally find common ground and are able to firm up the price that is suitable to each of them.

The question remains: is the price at which Bob and Sally agree to transact considered the fair market value of Targetco?

To Bob and Sally, the agreed-upon price may indeed be what each considers to be the fair market value. If Bob and Sally are happy with the outcome, one might think that this is all that matters. However, because the Targetco shares represent a capital asset, the transfer of the shares from Sally to Bob, in fact, is a disposition of capital property, and a disposition typically results in tax consequences.

Copyright © 2019 The Institute for Advanced Financial Education.

If Bob and Sally are considered to be dealing at arm's length, then the price they agree upon would generally be acceptable for income tax purposes. In arriving at the agreed-upon price, different factors come into play that will affect the net after-tax cost to Bob and the net after-tax proceeds to Sally.

It is common for the purchaser and vendor to each retain independent valuation counsel to assist in arriving at a value to optimize each of their net cost positions. Changing the circumstances could result in a very different scenario.

EXAMPLE (CONT'D)

Consider the situation where Bob and Sally are married spouses. Or, perhaps, Bob and Sally are adult siblings. Or, maybe they are parent and child. In each of these three circumstances, Bob and Sally are considered related under the provisions of the ITA (subsection 251(2)). This becomes important because paragraph 251(1)(a) of the ITA specifically says "related persons are deemed not to deal with each other at arm's length." The word "deem" means regardless of what the situation actually is, the ITA will apply its own outcome. As such, anytime related individuals are transacting, the IT will deem it to be a non-arm's length transaction.

Throughout the ITA, there are numerous anti-avoidance provisions designed as checks and balances to evaluate and, in some cases, place pre-defined parameters on non-arm's length transactions. With this in mind, if Bob and Sally are related, the price at which they transact when transferring the Targetco shares would be subject to greater scrutiny by the CRA. The importance of an independent business valuation takes prominence in non-arm's-length transactions.

Copyright © 2019 The Institute for Advanced Financial Education.

Fair Market Value

Although the term fair market value is used extensively across the ITA, it is not specifically defined within the ITA. The definition of FMV has evolved through jurisprudence, and the CRA sets out its interpretation in Information Circular 89-3, Policy Statement on Business Equity Valuations, dated August 25, 1989, at paragraph 3.

> Fair market value is the highest price, expressed in money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact.

The following are examples of where the ITA makes specific reference to the term FMV.

- **Transactions between arm's length parties:** The vendor is deemed to have received FMV on the disposition of an asset to an arm's length party. (Section 69)
- **Transfers of assets into a corporation on a rollover basis:** Transactions at less than FMV will be recalculated at FMV without any adjustment to elected amounts in respect of the transaction. (Section 85)
- **Transactions between a private company and its shareholders:** Any transaction between a company and its shareholder must take place at FMV or a shareholder benefit may arise. (Section 15)
- **Definition of the capital gains exemption:** The CGE definition incorporates the phrase, "fair market value of assets." (Section 110.6)

A non-arm's length transaction relies heavily on an independent valuation to derive the true FMV if the parties want to avoid potentially negative income tax consequences. Both non-arm's length and arm's length parties will use independent valuations to determine FMV important to sale and purchase negotiations.

Copyright © 2019 The Institute for Advanced Financial Education.

Valuation

There are two basic methods used to estimate a business value – capitalization of earnings and liquidation of assets. Both methods involve a broad array of criteria. Professionals whose role is to value assets typically hold a special designation referred to as a Chartered Business Valuator (CBV).

Capitalization of Earnings

Under the capitalization of earnings approach, share value is based on the firm's history of earnings using normalized earnings that are capitalized at an agreed-upon capitalization factor.

Normalization of earnings is a process of translating historical transactions into FMV on the basis that they are a fair representation of expected performance. Excess salaries and bonuses paid to shareholders are adjusted to a normal salary and bonus that would be paid to an employee.

Extraordinary items, those that are not expected to be repeated on a regular basis, are removed to better reflect normal business activities. By removing extra items, the financial statements reflect what a buyer could expect from the business going into the future.

For example, LMN Ltd. is a private company with the following financial results over the last five years.

		Current Year	Last Year	2 Years Ago	3 Years Ago	4 Years Ago
Net income before tax	A	$500,000	$500,000	$500,000	$200,000	$400,000
Bonuses paid to shareholders	B	$400,000	$200,000	$600,000	$100,000	$0
"Expected net income" (A + B)	C	$900,000	$700,000	$1,100,000	$300,000	$400,000
Weighting*	D	5	4	3	2	1
Factor (C x D)	E	$4,500,000	$2,800,000	$3,300,000	$600,000	$400,000

Copyright © 2019 The Institute for Advanced Financial Education.

*Used for averaging purposes. The most recent earnings have the highest weight. Using the information in the chart, the process continues:

1. Weighted average of row E is $733,000 ($11,600,000 / 15), where $11,600,000 is the sum of row E and 15 is derived as the sum of row D
2. Normal multipliers would be 4 through 6. (These are factors that represent typical industry ranges.).
3. The value is assessed at a range between $2,933,200 and $4,399,800. Values are typically assessed using ranges rather than a specific single target.

Notes to the above table:

1. Any reasonable salary amounts paid to shareholders for their contributions to the company as employees are reflected in the net income identified in row A because there is an expectation these salaries would have been paid regardless of shareholdings.
2. Bonuses paid to shareholders in excess of regular expected compensation for an employee doing equal work are added back in row B. It is common tax planning for bonuses to be paid to shareholders strictly as a strategy to suppress the net earnings to an amount that falls below the small business limit.
3. The analysis should consider whether any extraordinary items have been incurred in the last five years. If so, these amounts would require adjustment to better reflect true expected earnings. In the example above, there are no such items.

The capitalization of earnings approach is most applicable to “going concerns,” which are businesses that are expected to carry on as usual into the foreseeable future. Valuation is based on the continuation of earnings using history to estimate the level of expected future earnings.

Copyright © 2019 The Institute for Advanced Financial Education.

Asset-Based Approach

Under an asset-based approach, value is based on the physical assets owned by the company. In simple terms, this approach entails determining the FMV of each asset held by the company with the collective amount of all assets representing the total FMV of the company.

EXAMPLE

STU Ltd. is a service business operated by its two equal shareholders. A shareholders' agreement is in place with a buy-sell arrangement that stipulates that any sale/purchase under the agreement will take place based on the asset values within the firm. The shareholders decided on this methodology because of their advanced years, low prospect of selling the business to an independent third party, and the desire to ensure the survivor is not put in any financial hardship. Effectively, the survivor would be the only reasonably prospect to continue the business.

Assets of STU Ltd.	
	FMV
Chequing account	$10,000
Accounts receivable	$90,000
Inventory	$120,000
Equipment	$50,000
Land	$75,000
FMV of assets	$345,000
Liability of the company	$80,000
Net asset value	$265,000

Using the information in the chart, the firm's net assets are valued at $265,000. With two equal shareholders, a buy-sell between partners would be completed at $132,500 (50 percent of $265,000). This assumes there is value to the remaining partner who will continue the business.

Copyright © 2019 The Institute for Advanced Financial Education.

Under the asset approach to valuation, there are additional valuation methods that are more complex and beyond the scope of this course.

Comparison

Each of the capitalization and asset-based valuation methods can be used on their own, and each has positives and negatives relative to the circumstances. Quite often, a hybrid approach is utilized, encompassing elements of both methods to customize the valuation specifically to the client's circumstances. It is common to generate a range that is used to encourage discussion about whether the reasonable value is closer to one end of the range or the other during the process of negotiations.

Integration into a Shareholders' Agreement

The buy-sell arrangement of a shareholders' agreement will reference the selling price that should be used if a buy-sell is triggered. There are several methods by which the shareholders' agreement can refer to the price; no method is the only approach and each method will have its own advantages and disadvantages.

For arm's length shareholders, the agreed-upon transaction value flows through to the income tax calculation. However, for non-arm's length individuals, the CRA reserves the right to tax the vendor based on the true FMV.

In an arm's length shareholder agreement, the selling price can be decided by the shareholders using pretty much any approach that they decide is acceptable. The following is a discussion of the more common approaches to determining price, depending on the type of event triggering the buy-sell.

Copyright © 2019 The Institute for Advanced Financial Education.

Book Value

This straightforward approach simply uses the book value of the corporation at the date of the triggering event (i.e., shareholder's death, disability, or agreement to separate). Book value is determined by looking to the balance sheet of the corporation and subtracting the liabilities from the reported value of the assets to derive book value.

The downside of this method is that it uses a historical perspective for valuation, which does not reflect the true market value of the firm's assets, its earnings capacity, or any type of goodwill associated with the business operation.

This approach may be appropriate for corporations with few assets where the value of the company is closely related to its retained earnings.

Book Value Plus Fair Market Increments

The book value plus fair market increments method is considered an enhancement on the book value method in that the historical cost of the assets is replaced with the asset's FMV. The formula then becomes the FMV of the assets in excess of the liabilities of the corporation.

This approach may be appropriate for those corporations that should be valued based on their asset value rather than their income earning potential.

Fixed-Value

The fixed-value method relies on the shareholders to agree to a value on an annual basis and record such agreement in an appendix to the shareholders' agreement. Typically, there is some basis upon which the value is driven, such as a formula or an adjustment to a prior valuation.

A drawback to this method is the fact that the value becomes fixed and does not reflect the current value of the firm – value could be over- or understated. One way to overcome the static nature of this approach is to adjust the last agreed-upon value by some factor from the financial statements such as changes to sales or gross profit.

Copyright © 2019 The Institute for Advanced Financial Education.

This approach may be appropriate in arm's length situations where the shareholders have a good knowledge about the value of the corporation.

Valuation

In the case of the valuation method, the shareholders' agreement would call for the engagement of a professional valuator to determine the FMV of the corporation or perhaps the value of the shares under the buy-sell arrangement. Sometimes shareholders' agreements allow the vendor and buyer to each engage their own professional valuator, and the average of the values is used in the buy-sell arrangement.

A weakness of this method is that value is not really known until the occurrence of an event, which makes proper funding difficult. When this method is utilized, the shareholders' agreement should provide for how a deficiency in funding is to be addressed.

This method may be appropriate when the shareholders do not know the value of their corporation but each wants to ensure that their family will receive the full value.

Formula

Under the formula method, the shareholders' agreement depicts a formula through which the value for buy-sell purposes is derived (e.g., four times the average net income before tax).

A downside to this approach arises because it is typical to use tax planning in private companies to maximize after-tax income to the shareholder's specific circumstances. If, for example, tax planning is used, the net income reported by a private company may be higher or lower than "normal" net income when all transactions take place at FMV without shareholder-specific tax planning.

An example of tax planning arises when there is a salary or bonus payment to a shareholder in order to reduce net income for purposes of accessing the small business deduction. When a private company "bonuses down to the small business deduction limit," the resulting bonus is seldom the FMV.

Copyright © 2019 The Institute for Advanced Financial Education.

Shareholder Relationships

The relationship between shareholders is important in terms of whether the value established by the shareholders' agreement would be determinative of the FMV of the shares. The buy-sell arrangement establishes the price at which the shareholders have agreed to transfer the shares between each other. The value established by the buy-sell arrangement will be the value paid by the buyer and the value received by the seller.

As noted earlier, the CRA reserves the right to disregard the price established by the agreement in a non-arm's length situation. In a non-arm's length situation, the CRA will want to determine the FMV of the shares independent of the shareholders' agreement, which could have unanticipated income tax consequences.

EXAMPLE (CONT'D)

Recall from the earlier discussion about Bob and Sally that if Bob and Sally are non-arm's length – perhaps a parent and child – the CRA deems them not to deal at arm's length. There is the perception that non-arm's length persons may seek to use a low value in their buy-sell arrangements in order to benefit each other.

If Bob is retiring and selling his shares of Targetco to Sally, Bob could be motivated to suppress the value at which he transacts with Sally. Assume Targetco's true FMV is $8 million but Bob decides he really does not need $8 million out of the business for retirement. His financial projections show he could live quite nicely with $5 million. By charging Sally only $5 million, it saves Sally $3 million and it saves Bob taxes on $3 million. Perhaps Sally is Bob's only heir so there is no long-term consequence to other family members because of this special negotiation. If Sally was one of several heirs, Bob could decide to reflect this benefit to Sally in his final estate distribution plan.

Copyright © 2019 The Institute for Advanced Financial Education.

Special Pricing

While not all transactions between non-arm's length parties reflect "special pricing," the ITA sets the stage to protect itself from this potential. This is an important issue because while the shareholders' agreement will dictate the value received by the seller, the CRA may establish a tax liability based on the true FMV, which will have financial repercussions.

EXAMPLE

Annie and Pat, mother and daughter, are equal shareholders of Pillow Corp. The pair has a buy-sell arrangement in place. Assume Pat passes away, and Annie purchases Pat's Pillow Corp shares for $1,000,000, irrespective of the FMV.

Consider the following three scenarios where the transaction takes place at different values:

	Scenario A	Scenario B	Scenario C
Buy-sell value	$1,000,000	$1,000,000	$1,000,000
Fair market value	$1,000,000	$2,000,000	$5,000,000
Tax liability (1)	$225,000	$450,000	$1,125,000
After-tax to family	$775,000	$550,000	($125,000)

Notes:

(1) The tax liability assumes no ACB on the shares, a 50 percent capital gains inclusion rate, and a 45 percent marginal tax rate.

In **scenario A**, the amount paid by Annie to Pat's estate is an exact reflection of the FMV of Pat's shares. The tax liability is based on the price established by the agreement and there is no surprise to Annie or Pat's estate.

In **scenario B**, the $1 million paid by Annie to Pat's estate based on the agreement is only one-half of the FMV of Pat's shares. This results in a tax liability of $225,000 more than what would have been paid if the transaction had taken place at FMV. Why? Because the shareholders established a price that was $1 million less than true FMV. With $1,000,000 of sales proceeds, as established by the buy-sell arrangement, the family only has $550,000 left after taxes.

Copyright © 2019 The Institute for Advanced Financial Education.

Scenario C magnifies the negative outcome because the agreement price and FMV are even further apart. In scenario C, the strategy of a low buy-sell price costs the family significant value as shown above, because the resulting tax liability was greater than the transaction price. In this case, the estate has to fund the shortfall of $125,000 out of other assets.

Price Adjustment Clause

When non-arm's length persons are transacting, a special agreement referred to as a "Price Adjustment Clause" (PAC) is often added into the shareholders' or sale-purchase agreement. The price adjustment clause is designed to mitigate the negative consequences that could arise if the CRA disputes the FMV amount assigned to the transaction. The following discussion[9] looks at the design, and application of the price adjustment clause.

Managing the Risk of a Punitive Outcome

The Canada Revenue Agency (CRA) provides the opportunity to mitigate punitive income tax consequences arising from a miscalculation of the FMV on a transaction when the parties incorporate a valid Price Adjustment Clause (PAC). In general terms, a PAC is a clause in an agreement entered into by non-arm's length parties that provides a mechanism to adjust the FMV of the property should the CRA or courts of law disagree with the original valuation.

Non-arm's length parties generally include the spouse of an individual taxpayer and the taxpayer's direct ascendants and descendants, along with the taxpayer's siblings. Spouses of the taxpayer's direct ascendants, descendants and siblings are typically included in this group. For example, assume Martin is the taxpayer. Martin's spouse, along with his children,

---

9 Adapted from *Comment*, Edition 288, November/December 2014, James Kraft and Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

grandchildren, parents, grandparents, and siblings would typically be considered non-arm's length to him. As well, the spouses of all the foregoing would be non-arm's length to Martin.

This wide inclusion is very important because the parties to a non-arm's length agreement will be taxed based on FMV regardless of the original transaction price in an agreement. While the income tax consequences will be adjusted for both parties to reflect the revised FMV, a PAC can prevent adverse tax consequences that would otherwise arise from the application of anti-avoidance provisions. Examples of this include the shareholder benefit rules, the attribution provisions, and the benefit rules that apply to tax-free rollovers or a share-for-share exchange.

Conditions for a Price Adjustment Clause

A price adjustment clause is not a simple safety net inserted into non-arm's length transaction agreements in order to minimize negative consequences. To have the intended mitigating effect, the PAC must be considered a valid clause, which means it must meet specific conditions, including the following:

- **There must be a *bona fide* intention to transfer at FMV.**
- **FMV must be determined in good faith and using a fair and reasonable method.** The CRA suggests that a significant difference between the original FMV of the transaction and the adjusted "real" FMV may indicate that the parties did not undertake a genuine effort.
- **The valuation method must be properly applied with regard to the specific circumstances.** For example, it may not be reasonable to use a liquidation method to establish the value of a financially viable and profitable going concern.
- **Valuation experts are not required**; however, they can be helpful to ensure the valuation method chosen is reasonable and considers all relevant circumstances.
- **The shortfall or excess on the adjusted price must be refunded, paid between the parties, or adjusted as a legal liability.**

Copyright © 2019 The Institute for Advanced Financial Education.

Failure to meet the CRA's requirements would mean that the price adjustment clause is disregarded, and the parties would be subject to the resulting negative consequences arising from the application of any relevant anti-avoidance provisions.

Scenario 1

In 2012, Carlie exchanged her common shares of Opco, taking back consideration comprised of redeemable, retractable, fixed-value preferred shares valued at $10 per share. The $10 redemption value of the preferred shares was set at the FMV of the Opco common shares at the time of the exchange. There was a price adjustment clause completed in case the FMV of the Opco common shares was changed because of an audit arising by the CRA.

The price adjustment clause provided that if the preferred shares were redeemed before any adjustment to the FMV, the corporation would be liable for paying any additional proceeds to Carlie. Opco redeemed 10 shares each month in 2013 and 2014. In January 2015, the CRA issued their opinion that the original value of the shares was actually $15 per share. The firm accepted the CRA's assessment and, in February 2015, the firm paid Carlie an additional $5 per share for the 240 shares that had been redeemed.

Outcome:

It is the CRA's view that the additional payment of $5 per share to Carlie in 2015 relates to the redemption of the Opco shares, and would be treated as a dividend. The additional payment arises from a right relating to the share and would be subject to taxation in the year of receipt (2015). The payment would not be treated as a retroactive redemption, but rather a current payment of a dividend at the time of receipt based on the interpretation of the provision for the redemption of shares.

Copyright © 2019 The Institute for Advanced Financial Education.

Scenario 2

Mom sells the common shares of her operating company (Opco) to her daughter for $3,000,000, even though they have a sense that the FMV is probably closer to $5,000,000. Mom and daughter derived the $3,000,000 value based on an amount they felt mom needed for retirement.

Based on the original sale price, mom reports a $3,000,000 capital gain assuming a nominal adjusted cost base. Daughter's adjusted cost base is $3,000,000, which represents the amount she paid to mom for the shares. Mom and daughter put a price adjustment clause in their transfer agreement.

A subsequent re-assessment by the CRA, and validated by the Tax Court, determined the FMV was $5,000,000, not $3,000,000, at the time of the original transaction. They also found that the price adjustment clause was not valid based on a review of the circumstances surrounding the valuation.

Outcome:

While a price adjustment clause was in place, the finding that it was not valid results in the application of anti-avoidance rules. The income tax outcome of an invalid price adjustment clause is the same as not having one in place. Mom will be reassessed and taxed on deemed proceeds of $5,000,000, the revised FMV of her shares. However, the daughter's adjusted cost base is not eligible for a similar adjustment; instead, her adjusted cost base remains at $3,000,000. Eventually, when the daughter sells the Opco shares, her overall capital gain will include the $2,000,000 capital gain already reported by her mother.

If the price adjustment clause had been valid, the daughter would have been required to pay mom an additional $2,000,000 to reflect the revised FMV, and mom would have paid tax on the additional $2,000,000 (now $5,000,000 rather than original $3,000,000). The daughter's adjusted cost base would have increased to $5,000,000.

Price adjustment clauses can be an extremely valuable tool in agreements between non-arm's length parties. However, they will only be successful in situations where it is clear that the parties had a legitimate intention to transact at FMV.

Copyright © 2019 The Institute for Advanced Financial Education.

Corporate-Owned Insurance – Valuation

This section examines various scenarios that might arise when valuing the shares of a private corporation at the death of a business owner and provides illustrations of the application of the CRA's valuation methods.

When the owner of a private business or corporation dies, the valuation of his interest in the business is usually based on a valuation of the business' future earning potential and the value of redundant assets, which include life insurance policies. When valuing these policies there are deeming rules and valuation practices depending on the relationship between each individual shareholder and the life insured.

Statutory Provisions

Upon the death of a taxpayer, there is a deemed disposition of all capital assets owned by the deceased that results in the realization of any accrued capital gain in the assets. If those capital assets include shares of a corporation, the valuation of those shares will be critical in determining the tax liability arising on the deceased's terminal tax return.

When the corporation owns life insurance, there are two possible scenarios.

1. The ITA provides a deeming rule such that the value of a life insurance policy is the policy's cash surrender value, if the policy insured the shareholder who has just passed. This rule applies irrespective of other factors, such as the deceased's state of health immediately prior to death. This rule applies to the life insurance policies on the deceased and parties related to the deceased.
2. Valuation principles would be applied to all other policies, taking into consideration all relevant data such as health and life expectancy, which could significantly increase the value of the life insurance policy and therefore the value of the shares of the corporation.

Copyright © 2019 The Institute for Advanced Financial Education.

EXAMPLE 1

Jacob died on February 1 of this year. His death was not unexpected, as he was diagnosed with a terminal illness in June of last year and was expected to live about six more months. On his death, Jacob owned 100 percent of a corporation (Opco) that owned a life insurance policy with Jacob as the life insured. It was a whole life non-participating insurance policy with a face amount of $300,000 and a cash surrender value of $32,000. The insurance policy was payable to Jacob's corporation. When valuing the shares Jacob held in Opco, the policy is deemed to have a value of $32,000; its cash surrender value.

EXAMPLE 2

Ron and Rhonda (no relation to each other) each own 50 percent of R&R Ltd. R&R owns a $250,000 life insurance policy on each of their lives, for purposes of a buy-sell arrangement. There is only a nominal amount of cash value in the policies.

If Rhonda passes away, the valuation of her shares of R&R will take into account the deemed value of the life insurance policy on her life. The deemed value of Rhonda's policy would be its cash surrender value. However, in valuing Rhonda's shares, the policy on Ron's life would be valued taking into account normal valuation techniques. Why? The deeming rules do not cover the policy on Ron's life, as he is arm's length to Rhonda.

Copyright © 2019 The Institute for Advanced Financial Education.

Normal Valuation Principles

If at the time of death, a corporation owns life insurance policies on individuals who are not related to the deceased, the deeming rules do not apply. Instead, the life insurance policies on the non-related individuals must be valued in order to determine the value of the shares held by the deceased shareholder. The value of these policies (on the lives of non-related individuals) is established through normal valuation principles.

The CRA has defined elements it feels should be considered in the valuation of a life insurance policy. These elements are set out in Information Circular IC 89-3, Policy Statement on Business Equity Valuations, dated August 25, 1989, at paragraphs 40 and 41. They are:

- Cash surrender value of the policy;
- Loan value of the policy;
- Face amount of the policy;
- State of health/life expectancy of the life insured under the policy;
- Conversion privileges under the policy;
- Riders attached to the policy;
- Replacement value of the policy.

The process of valuation would typically generate several figures and ranges taking into account each of the items in the above list. The specific value used in a transaction, such as the death of a shareholder, would be based on the range developed in the valuation process.

This process needs to be undertaken every time a shareholder transacts with his shares, including the death of a shareholder.

Copyright © 2019 The Institute for Advanced Financial Education.

Cash Surrender Value of the Policy

Generally, the cash surrender value (CSV) of the policy is the starting point for valuation. This is the amount that the life insurance company is willing to pay in cash, at the request of the policyholder.

Some life insurance policies have a guaranteed cash value that will materialize in the near future, such as term-to-100 policies that have a large CSV only at the end of their twentieth policy year. The value of these types of policies could be based on the present value of the cash value that will arise in the future.

State of Health/Life Expectancy of the Life Insured Under the Policy

If the life insured is in unusually poor health and/or is expected to die in the near term, the valuation of the policy could approach the face amount of insurance.

EXAMPLE

ABC owns a term-to-100 life insurance policy on the life of Anthony, a key employee. The policy has a face amount of $250,000, with no cash surrender value. Anthony has recently been diagnosed with liver cancer and has only one year to live. The policy will likely be valued very close to its face amount (i.e., face amount discounted one year, less any premiums due), if a valuation of ABC was required.

Copyright © 2019 The Institute for Advanced Financial Education.

Conversion Privilege

The right to convert a term insurance policy into a permanent insurance plan may have significant value. Value could arise if the insured cannot get new insurance or would not qualify for new insurance at the rates offered under the conversion option.

EXAMPLE

BCD Corp. owns three term insurance policies on the lives of its three shareholders. The policies are all scheduled to expire within the next two years.

- B is healthy and can qualify for a new insurance policy that will cost about the same as the converted policy. The policy on B's life will likely have very little value if a valuation was required outside of the deeming rules.
- C is in poor health and, while he could qualify for a new life insurance policy, the policy would be rated at 200 percent. The policy on C's life will likely have some value because a new policy would cost twice as much as the converted policy (if a valuation was required outside of the deeming rules).
- D is in poor health and has been declined for a new life insurance policy. The policy on D's life will likely have significant value because new insurance is not available and the existing term policy can be converted.

Policy Riders

The principles of valuation applied to a policy rider are the same as those applied to the base policy (i.e., cash value, loan value, face amount, state of health, conversion privileges, etc.).

Copyright © 2019 The Institute for Advanced Financial Education.

Policy's Replacement Value

A policy could be valued taking into consideration the difference between its cost and the replacement cost, if the replacement cost is higher than the cost of the current policy. In this case, the **replacement value** would be based on the present value of the difference in premium costs.

EXAMPLE

EDI Inc. owns a $100,000 term-to-100 policy on the life of a key executive, Andrew. The policy has no cash surrender value at the present time. Currently, the policy costs $2,000 annually, while a replacement policy would cost $5,000 annually. The policy on Andrew’s life could be valued at the present value of $3,000 annually ($5,000 replacement less $2,000 current costs) for the period remaining in Andrew’s life expectancy.

Buy/Sell Arrangements

If the deceased’s shares are subject to a shareholders’ agreement with a pre-arranged method for determining the business value, that price will provide evidence as to the value of the business interest for purposes of the deemed disposition rules. This assumes arm’s length parties under the agreement.

However, for non-arm's length situations, the CRA has indicated that the price set out in the shareholders’ agreement could be challenged if the CRA determines that it is not a reflection of the true FMV of the shares. Corporate-owned life insurance on arm’s length parties can influence the value of the shares.

This means an agreed-upon value between arm’s length parties will override the CRA’s ability to value the corporate-owned life insurance policies and possibly inflate the value of the shares of the company.

Copyright © 2019 The Institute for Advanced Financial Education.

Capital Gains Exemption

Corporate-owned life insurance can also impact the shareholder's ability to claim the capital gains exemption. This can arise because of the "90 percent test" (QSBC qualification) at the time of disposition. The definition of a QSBC requires that all or substantially all of the FMV of the assets of the company must be used to carry on an active business primarily in Canada.

Corporate-owned life insurance can impact the 90 percent test in the following ways:

- The cash value of the corporate-owned life insurance policies is considered a passive asset, regardless of whether it is reported on the company's balance sheet as an asset;
- The FMV of the corporate-owned life insurance policies in excess of amounts required for buy-sell needs is considered a passive asset. Examples, when this could occur, include executive coverage on the shareholders, collateral coverage on the shareholders, and excess buy-sell coverage on the shareholders' intended future growth.

Life Insurance Impact on Share Valuation[10]

Life insurance is used in a wide range of corporate and personal estate planning strategies. When the life insurance policies are corporately owned, there can be implications to the tax valuation of the corporation's shares. This needs to be taken into account when implementing the chosen estate planning strategy.

A given corporation may own life insurance policies on the life of the deceased shareholder, a surviving shareholder, a party related to one of the shareholders, a key person, and/or on the life of an unrelated third party.

When valuing the shares held by a deceased shareholder, there is a deeming rule imposed for income tax purposes. In that situation, only the cash surrender value of life insurance policies on the life of the deceased, or on the life of a person who did not deal at non-arm's length with the deceased, is taken into account. This means all insurance policies owned by the corporation on the life of the shareholder, the shareholder's

---

10 Adapted from Comment, Edition 263, September/October 2010, James Kraft & Deborah Kraft

Copyright © 2019 The Institute for Advanced Financial Education.

spouse/common-law partner or children would have a deemed value equal to the respective policy's cash surrender value. In addition, any policy where the deceased is one of the insured lives will also be subject to the deeming rule. This means joint last-to-die and multi-life contracts would also be subject to the deeming rule. The amount of cash surrender value would be determined without regard to any policy loans against the policy. The relationship with respect to life insurance on a related party may exist either at the time of issue or at the time of death.

However, all other corporate-owned life insurance policies will be valued at FMV when determining the value of the shares held by the deceased.

Buy-Sell Arrangement

Consider the situation of a buy-sell arrangement between two unrelated shareholders for their corporation that they own equally.

The arrangement is funded by corporate-owned life insurance. Even though their shareholders' agreement sets out a price for a buy-sell transaction, the ITA would still dictate that the deemed disposition upon death would take place at the FMV of the shares. Upon the death of the first shareholder, his shares would be valued after having taken into account the CSV of the policy on his own life plus the FMV of the policy on the life of the surviving shareholder. If the health of the surviving shareholder had declined significantly since the policy was issued, or if the cash surrender value of the policy was minimal in the early years of the contract that second life insurance policy could be worth significantly more than its cash surrender value.

The FMV of a life insurance policy is not easily determined. The CRA has issued guidance on some of the factors that should be taken into account when determining FMV (Paragraph 40 of Information Circular 89-3, Policy Statement on Business Equity Valuation). These include a wide range of factors, including the cash surrender value of the policy; the policy's loan value; the policy's face value; the state of health of the life insured and his or her life expectancy; the policy's conversion privileges; any other policy terms, such as term riders or double indemnity provisions; and, the replacement value of the policy. All items in this list are fact-based. While

Copyright © 2019 The Institute for Advanced Financial Education.

some can be objectively measured quite easily, others (such as the state of health of the life insured and his or her life expectancy) are somewhat subjective.

It should be noted that corporate-owned life insurance can cause the company shares to be ineligible for the enhanced capital gains exemption because of a complex set of rules and valuations that are beyond the scope of this article. Seek the help of a tax professional whenever corporate-owned life insurance is used in an estate plan.

Copyright © 2019 The Institute for Advanced Financial Education.

Summary

After completing this module you should be able to:

- Utilize the concept of an estate freeze to address a client’s objectives;
- Apply strategies associated with transitioning a business to a subsequent owner;
- Understand the valuation of business entities and corporate-owned insurance.

Copyright © 2019 The Institute for Advanced Financial Education.

CLU 256

Tax & Legal Principles for Businesses and their Owners

2019 Edition

This course focuses on wealth transfer and estate planning strategies for businesses and business owners. The course includes:

- A description of the legal and tax implications of certain business structures, specifically sole proprietorships, partnerships and corporations with particular attention to tax planning strategies and the issues to be addressed at the sale or transfer of the business or at the death of a principal;
- A special focus on the tax complexities present in the operation of a corporation;
- The consideration of planning strategies for the orderly and tax-efficient of business wealth at retirement upon death.

Tax & Legal Principles for Businesses and their Owners is course six of a seven course program in the CLU designation program.

The Institute™
for Advanced Financial Education