

COMMENT

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Double Taxation

Double taxation is bad because it generally means that tax is being paid twice on the same income. Double taxation can occur in an estate when assets with an accrued capital gain are held in a holding company. For example, it can occur if a businessman holds his company's real estate in a separate company and opts to retain the real estate after the business is sold, or if an investment portfolio is held in an investment company and it continues to grow over time.

The first level of tax occurs when the death of the shareholder triggers the realization of the accrued capital gain in the shares of the holding company. The second level of tax occurs when the holding company sells its assets and triggers the realization of the accrued capital gain on the asset (i.e., real estate or investment portfolio). A third level of tax could occur as the estate's executor winds up the company in order to access the cash value of the investment.

Consider the following example of a piece of real estate owned by a holding company that is in turn owned by an individual. The real estate is an industrial property that was previously used to house Mr. X's operating company. The operating company was sold and Mr. X opted to retain the property as an investment.

Mr. X owns Holdco

Adjusted cost base (ACB) of his shares is nominal

Paid-up capital (PUC) of his shares is nominal

Fair market value (FMV) of his shares is \$1,200,000

Holdco owns a industrial rental property

ACB of the land is \$200,000

ACB of the building is \$300,000

Undepreciated capital cost (UCC) of the building is \$100,000

FMV of the property is \$1,200,000

Upon Mr. X's death, he is deemed to have disposed of all of his capital property, which would include his shares of Holdco.

Deemed proceeds of disposition	1,200,000
Less his adjusted cost base	Nominal
Capital gain	1,200,000
Taxable capital gain (50%)	600,000
Estimated taxes thereon (45%)	270,000

If Holdco were to subsequently sell its rental property, the following results could be expected.

	Total	Land	Bldg
Proceeds of disposition	1,200,000	480,000	720,000
Less adjusted cost base		200,000	300,000
Capital gain		280,000	420,000
Taxable capital gain (50%)	350,000	140,000	210,000
Recaptured CCA	200,000	N/A	200,000
Taxable income	550,000		
Estimated taxes thereon (50%)	275,000		
Net cash after tax	925,000		
Estimated RDTOH* in taxes	145,000		
Credit to CDA**	350,000		

*refundable dividend tax on hand (RDTOH) is equal to 26 2/3 per cent of the aggregate investment income (i.e., the taxable capital gain plus the recaptured CCA)
**capital dividend account (CDA) credit is equal to the non-taxable half of the capital gain on the land and buildings

Finally, the executor decides to wind up Holdco in order to have cash for estate expenses and payments to beneficiaries. From a tax planning point of view, the company would first pay out a capital dividend and then a taxable dividend that would take into account the value in the company's RDTOH account.

Cash position of Holdco	925,000
Capital dividend	350,000
New cash position	575,000
Maximum taxable dividend	720,000
Estimated taxes thereon (30%)	216,000
Cash position of executor*	854,000
Less taxes triggered in the estate**	270,000
Final cash position	584,000
As a percentage of FMV	48.7%
Effective tax rate	51.3%
*equal to the capital dividend of \$350,000 plus the net cash on the taxable dividend of \$504,000 (\$720,000 minus \$216,000)	
**on the deemed disposition on death (see above)	

The above example demonstrates that over 50 per cent could be lost in taxes because of the double tax problem. Here, of the \$1,200,000 in fair market value proceeds, only \$584,000 remains after tax.

However, careful post-mortem planning can significantly reduce the impact of the double taxation problem described above. The strategy would involve utilizing the executor's high ACB in the shares of Holdco, the creation of a new holding company (Newco), the windup of Holdco into Newco and finally a tax election to bump the ACB of Holdco's assets as they pass to Newco. This is a fairly complicated tax transaction and should only be completed by competent tax professionals.

That said, the following would be the results.

1. The executor would transfer the shares of Holdco into Newco taking back a promissory note for \$1,200,000 being the amount equal to the ACB of the shares of Holdco and some common shares that would have nominal value. At this point, the estate would own Newco and Newco would own Holdco.
2. Holdco would be wound up into Newco. The windup of Holdco into Newco allows the opportunity for an election that could bump the ACB of the assets held by Holdco that are now being transferred to Newco.

Income Splitting

The usual objective of income splitting is to lower the overall tax load of the family. Most commonly, income can be split between spouses or between parents and children. This article will deal with income splitting with one's spouse. It should be noted that for income tax purposes, a "spouse" includes a common-law partner, including a same-sex partner.

The trouble with trying to minimize tax through income splitting is that the Income Tax Act contains a tremendous number of anti-avoidance measures to minimize a taxpayer's ability to income split and therefore lower his or her overall income tax liability.

Under the attribution rules of the Act, income on property transferred to a non-arm's-length person can be attributed back to the transferor. For example, if one spouse earns investment income or a capital gain

3. After the windup of Holdco into Newco, Newco would sell the assets and, because of the bump in the ACB, it would be able to avoid the realization of the capital gain. While the recapture would still trigger some taxes, the overall tax liability would be reduced.

4. The after-tax proceeds from the sale of the real estate would be used to repay the promissory note established in step one.

Newco should be able to sell the real estate with the following income tax results:

	Total	Land	Bldg
Proceeds of disposition	1,200,000	480,000	720,000
Less adjusted cost base		480,000	720,000
Capital gain		Zero	Zero
Taxable capital gain		Zero	Zero
Recaptured CCA		N/A	200,000
Taxable income	200,000		
Estimated taxes thereon (50%)	100,000		
Net cash after tax	1,100,000		
Estimated RDTOH in taxes	53,000		
Credit to CDA	Zero		

The net cash available to the executor after this post-mortem tax planning strategy would be \$1,100,000 less \$270,000 or a net after-tax cash position of \$830,000, which represents 69.2 per cent for an effective tax load of 30.8 per cent. Planning allowed a tax reduction of \$246,000.

Planning is available to those who are aware of issues in their circumstances. It is important to involve insurance, tax and legal advisors to ensure the best possible tax results in complex situations.

I/R 7401.00

on property that was gifted from the other spouse or transferred at an amount less than fair market value, all of the investment income and capital gain would be attributed back to the contributing spouse and taxed in his or her hands.

This rule would also apply to investment income and capital gains earned on property that was purchased with interest-free or low interest loans (with one exception, noted in the second point below) from the first spouse. It should be noted that even if the second spouse repays the interest-free loan from other property, the attribution rules would continue to apply.

The spousal attribution rules will continue to apply until the gift or loan is reversed, the death of one spouse, a divorce of the spouses or until 90 days following a separation of the common-law partners.

Careful planning will allow the spouses to split income by following one or more of the following strategies.

- 1) Investment income and capital gains can be split between spouses if the income/gain is earned on property that has been transferred at fair market value. This would include property that is sold at fair market value from one spouse to the other. This could create a taxable capital gain in the year of the transfer, however.
- 2) One spouse could also lend money to the other in order to facilitate the purchase of an investment. Loans between spouses require that interest be charged at a minimum rate equal to the prescribed rate in effect under the tax legislation when the loan was established. In addition, interest must be paid annually by at least 30 days following the year-end.
- 3) So-called “second generation” income, or income earned on the reinvested income from the asset,

does not attract attribution. This strategy requires keeping meticulous records of the attributed income and separating future income earned on that attributed income.

- 4) Money can be lent from one spouse to the other to fund a private business. In such a case, the income generated from the private business is not subject to attribution. Of course, there is risk of loss of the funds in this scenario.
- 5) Pension income can be split between spouses under the rules introduced in 2007.

Income splitting, if done with care and expert advice, can lower the overall income tax load of the family and leave more cash for lifestyle needs or enhanced accumulation.

I/R 2500.13

RCA, Dead Or Alive?

Retirement compensation arrangements (RCAs) were introduced into the Income Tax Act as an anti-avoidance measure in 1986. At that time, the Department of Finance needed a measure in the Act to prevent not-for-profit, charitable, municipal, sport and other organizations that were not concerned about tax deductions from setting aside large amounts of executive income into deferred plans on behalf of their executives.

The anti-avoidance measure was a special flat tax of 50 per cent on contributions to unregistered retirement plans and on realized investment income in those plans. That tax rate was a little bit higher than the top marginal tax brackets in all of the provinces and higher than most corporate tax rates for those companies and organizations that were subject to tax. Since 1986, the top marginal brackets have risen and declined, resulting in some advisors offering blanket advice on whether RCAs are “dead or alive” depending on the taxpayer’s top marginal tax bracket.

The truth of the matter is that sound planning depends on the specific facts of each situation and the taxpayer’s objectives.

A second truth is that planning should not begin with numbers, but rather an overview of the alternatives from a logical and common sense point of view that takes into account the facts of the situation and the taxpayer’s objectives. Then, numbers can play a role in measuring the alternatives.

Consider the situation of an individual who owns a small business corporation. The individual draws out enough income to meet his needs and any additional income that he withdraws would be taxed at the top marginal tax rate. He decides that he wants to set aside some current income for his future retirement needs. Assume that he has already maximized his contributions to registered pension and retirement savings plans. He is considering leaving the funds in his company, drawing

out the funds and investing personally or utilizing an RCA and accumulating the after-tax amounts.

The analysis will depend on a great number of factors, such as the corporation’s tax rates on active income and on passive income, the individual’s current marginal tax bracket and his estimated future marginal tax bracket as well as his average tax rate. Costs associated with the various options must also be accounted for. For example, there are setup and administration costs associated with an RCA. In addition, there are a great number of variables that defy easy measurement, such as creditor protection of the funds, access to the capital gains exemption, extreme plans like moving offshore, etc.

Current income accumulated in the corporation would first be subject to corporate tax, which could be assumed to be based on the small business rate. However, the investment income realized on the investment accumulation inside the company would be subject to the top corporate rate plus an additional tax called additional refundable tax. A portion of the corporate tax would be refundable but only when the company pays taxable dividends to its shareholders, thus reducing the funds available within the corporation for investment. As noted above, one of the non-measurable issues is creditor sheltering. Funds accumulated in a company would be subject to claims by the company’s creditors.

Current income could be paid out of the company to the shareholder, who would then be subject to tax on this extra income. Because income to fund his current lifestyle needs will have used up the lower marginal tax brackets, any extra income would be subject to tax at the top marginal tax rate as assumed above. By drawing the income out of the company, the tax liability is immediately triggered, leaving only the after-tax balance for investment. While creditor protection has not been completely avoided, it has been limited to the shareholder’s own creditors and potentially protected from the company’s creditors.

Alternatively, some of the company's current income could be contributed to an RCA to be held and accumulated to subsidize the shareholder's eventual retirement income. (Note that the arrangement must be carefully structured to ensure its desired treatment as an RCA.) As already noted, an RCA is subject to a flat 50 per cent tax on contributions and realized income, but this tax is refundable when the RCA trust makes distributions to its beneficiary. There are no income tax consequences to the individual when the funds are contributed to the RCA, rather the individual will be taxed when the funds are distributed out of the RCA. The advantage of this structure is that the shareholder's ultimate taxation of the income is deferred into the future. This can be an advantage if the tax cost on income is lower in the future than today.

Accumulation Analysis	High Province	Low Province
Top marginal tax bracket	48.25%	39.00%
Pre-tax corporate income to be saved each year, at an assumed rate of 5%	100,000	100,000
Personal Accumulation		
Personal taxes paid	48,250	39,000
After-tax amount to be saved	51,750	61,000
After-tax value after one year	53,089	62,861
After-tax value after 10 years	597,170	722,287
Corporate Accumulation		
Corporate tax rate for active income	35.50%	29.50%
Corporate tax rate for passive income	50.67%	44.67%
Corporate taxes paid	35,500	29,500
After-tax amount to be saved	64,500	70,500
After-tax value after one year	66,091	72,450
Value of the RDTOH account	860	940
After-tax value after 10 years	739,304	821,686
Value of the RDTOH account	50,979	56,238

RCA Accumulation	High Province	Low Province
Refundable withholding taxes paid	50,000	50,000
After-tax amount to be saved	50,000	50,000
After-tax value after one year	51,250	51,250
Value of the refundable taxes	51,250	51,250
After-tax value after 10 years	574,173	574,173
Value of the refundable taxes	574,173	574,173

What remains to be analyzed is whether the individual's marginal tax bracket or his average tax rate at retirement should be taken into account when analyzing the alternatives. The marginal tax bracket may make sense if the individual realizes a great deal of income and any new income would be taxed at the top rate. The average tax rate may make sense if the individual's total income hovers around the top marginal bracket and new income would be received, essentially, at a blended rate.

Analysis of Alternatives	High Province	Low Province
Personal Accumulation	597,170	722,287
Corporate Accumulation	790,283	877,924
RCA Accumulation	1,148,347	1,148,347

The amounts of personal accumulation shown are net of personal income taxes paid. Amounts of corporate accumulation distributed to the shareholder will be taxed as dividends. Amounts paid from an RCA to an individual are fully subject to tax.

Corporate accumulation is better than personal accumulation if the individual's effective tax rate on dividend income is less than 24 per cent for a high-taxed province or 18 per cent for a low-taxed province. An RCA accumulation is better than personal accumulation if the individual's tax on regular income is less than 48 per cent for a high-tax province or 37 per cent for a low-tax province. The answer is not simple, but one of understanding the options available and how they could change over time or how options may vary if there is an adjustment to the assumptions.

Planning should not be subject to generic blanket rules nor be led by numbers. A retirement compensation arrangement may make sense in the right situation.

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