

COMMENT

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Choices To Be Made

Every owner of a private company faces the same dilemma: how to maintain one's lifestyle while continuing to grow the business and minimize current and future taxation. Tax minimization needs to be measured on both a current and deferred basis.

There are, however, no simple solutions. Every shareholder situation and taxation year is unique, and tax rates keep changing. The process of analysis must take into account the needs of the shareholder and the facts of the situation.

Accountants usually refer to this as the salary/dividend mix analysis. Depending on the cash flow needs of the shareholder and the tax account balances available to the corporation, the mix of salary versus dividends can be designed to minimize current taxation, thereby allowing the company to preserve more cash while the shareholder receives the same amount of after-tax income. The company could use the increased cash flow to carry more inventories, pay down debt or complete expansion plans.

The following table lays out the process of analysis. In this table, the comparison is between three extreme positions: 100 per cent salary and/or bonus; versus 100 per cent eligible dividend (i.e., a dividend paid out of corporate income that was taxed at the high corporate tax rate); versus 100 per cent ineligible dividend (i.e., a dividend paid out of corporate income that was taxed at the lower small business tax rate). The shareholder's objective in this situation is to preserve corporate

cash and build the company. The after-tax cash position of the shareholder is held constant in the analysis below in order to make the cash retained in the company the point of comparison.

	Salary or Bonus	Eligible Dividend	Ineligible Dividend
Corporate taxable income	1,000,000	1,000,000	1,000,000
Salary paid to shareholder	435,100	0	0
Corporate contribution to CPP	2,119	0	0
corporate tax rate below \$500,000	15.00%	15.00%	15.00%
corporate tax rate above \$500,000	30.00%	30.00%	30.00%
Corporate income tax liability	93,834	225,000	225,000
eligible dividend paid	0	311,700	0
ineligible dividend paid	0	0	337,530
corporate cash position	468,947	463,300	437,470
Salary received by shareholder	432,981	0	0
Dividend received by shareholder	0	311,700	337,50
Personal taxes paid by shareholder	182,994	61,724	87,528
Cash position of shareholder	249,987	249,976	250,002

Given the assumption of \$1,000,000 of corporate taxable income and the shareholder's need for \$250,000 income after tax, the optimal "extreme" is 100 per cent salary/bonus. Even taking into account the extra cost of CPP contributions at the corporate and personal level, the company has the most after-tax income to build the company.

Other considerations include:

- The payment of salary creates CPP/QPP contributions and, therefore, benefits.

COMMENT

- The payment of salary creates RRSP contribution room and, therefore, the ability to deduct deposits and defer tax during the accumulation period.
- The payment of a salary is tax deductible to the company, which may keep the company's taxable income within the small business limit, where the corporate tax rates are more favourable.
- The payment of a taxable dividend may trigger a refund of refundable taxes to the company.
- The payment of a dividend could be treated as a tax-free capital dividend to the extent that a balance is available in the corporation's capital dividend account.
- The payment of a dividend could be treated as an eligible dividend, which is taxed to the recipient less harshly than an ineligible dividend.
- The tax rate on eligible dividends is projected to rise as the corporate tax rates decline. This means that a complete analysis has to contemplate the increase to the long-term liability of paying eligible dividends in the future.

Compensation planning is a time-consuming exercise, but the value of the exercise is tax savings and cash flow preservation.

I/R 2400.00

Capital Dividend Appeal

The Federal Court of Appeal recently upheld a decision by the Tax Court of Canada in the case of *Innovative Installations Inc. v. The Queen*, where the taxpayer successfully recorded a credit to its capital dividend account for the settlement of a corporate debt secured by group creditor protection.

The case involved a private company with a debt to RBC. The company paid group term life insurance premiums to RBC, who in turn remitted them to Sun Life. On the death of the named person, Sun Life paid the insurance proceeds to RBC, who in turn discharged the debt of the company.

The Crown advanced two arguments in its appeal. First, it argued that the lower court ignored the form of the transaction – under which RBC rather than the company was the beneficiary of the group term coverage – in favour of the economic realities of the situation. Second, it argued that the lower court erred in treating the situation as a constructive receipt of life insurance proceeds.

The Federal Court of Appeal rejected both of the Crown's arguments and found in favour of the taxpayer. The form of the transaction involved

a contract between RBC and Sun Life, as well as a contract between RBC and the company. RBC was bound by contract to discharge the debt when it received the funds from Sun Life. In fact, the company could have sued RBC if it had failed to discharge the loan once the proceeds were paid by Sun Life.

The Federal Court of Appeal pointed out that subparagraph 89(1)(d)(ii) only requires the receipt of the life insurance proceeds and not a requirement for the company to be one of the named beneficiaries of the insurance policy.

Unless the Crown decides to appeal to the Supreme Court of Canada, the discharge of corporate debt by group creditor insurance appears to create a credit in the company's capital dividend account. It will also be interesting to see whether the principles enunciated by the court in this case have application in other insurance planning settings.

I/R 2101.07; 2121.00

Gifts By Will

A recent enquiry made to the Canada Revenue Agency (CRA) involved two questions with respect to the timing and amount of a charitable gift made in an individual's will:

1. How do you claim a gift made by will if the gift is not received by the charity by the due date for filing the deceased's terminal return?
2. How do you value the gift if the property changes in value between the date of death and the time the property is transferred to the charity?

When a donation is made by will, it is considered to be a donation made immediately before the time of death and, as such, a gift made by the deceased that can be claimed on the terminal tax return. A gift on the terminal tax return generates a tax credit, but only to a maximum of 100 per cent of net income reported on that return. Any gift in excess of this limit can be carried back one year and claimed on the prior tax return, again subject to a limit of 100 per cent of net income. However, from a practical point of view, such a gift may take some time to complete as the executor undertakes to complete an inventory of estate assets and obtain probate of the will.

For gifts completed before the terminal tax return is filed, the executor would include the official receipt from the named charity. For gifts that cannot be completed before the terminal tax return is filed, the CRA has indicated that the executor should claim the appropriate amount in the terminal return and provide a copy of the will, a letter from the estate to the charity advising of the gift, and a letter from the charity acknowledging the gift and its intention to accept the gift to document the gift.

In respect of the second question, the CRA responded that the value of the gift is to be determined at the date of death. Consider the example of an individual who bequeaths 1,000 shares of Public Co in his will to his favourite charity. Although at the time of his death the shares may be worth \$50 each, their value may be higher or lower at the time of physical transfer to the charity. The value of the gift will be \$50,000 irrespective of the actual value at the time of transfer. This is very important because values will often change between the date of death and the time of transfer.

It should be noted that where the value of the gift cannot be reasonably determined, no charitable gift tax credit will be allowed. This may arise, for example, in situations where the estate may not have sufficient financial resources to pay its liabilities, leaving insufficient assets for specific bequests.

I/R 1600.00

Scholarship Programs

As parents budget and save in order to be able to send their children off to higher education, employer-provided scholarship programs are a welcome bonus that should be explored. These programs can make a significant contribution towards the financial resources required to complete a post-secondary education.

If these types of scholarships are available, it is important to fully understand the resulting income tax consequences since any income tax payable will impact the total amount of after-tax funds available.

The Canada Revenue Agency (CRA) has recently changed its view on the taxability of employer-provided scholarship programs. Historically, the CRA viewed this as a taxable benefit to the employee. This position was challenged with the argument that the employee did not receive the benefit – in fact, it was the employee's child who used the scholarship to attend school.

The CRA's new position is that where the scholarship is provided in an arm's-length situation (i.e., no relationship between parent and employer) for post-secondary education, it is the student who is taxable. The student may be eligible to claim various tax credits associated with post-secondary education that will often defray most, if not all, of the income tax liability in respect of this benefit. The parent's employer will be responsible for reporting the taxable benefit to the student.

In non-arm's-length situations (e.g., where the business is owned by the parent), the CRA is maintaining its current position that it is the parent who is enjoying the benefit and who will be charged a taxable benefit. The relationship between the parent and the employer/company is a question of fact given the situation. Some of the criteria considered to determine whether a relationship is at arm's length would be:

- Is the parent a majority shareholder?
- If the parent is a minority shareholder, is she/he also a director of the company or in a senior management position?

In non-arm's-length situations, the CRA may seek to charge a taxable benefit to the parent under the employee benefit provisions of the Income Tax Act. However, it should be noted that to the extent the scholarship program benefits a child of a shareholder, the CRA could seek to charge a shareholder taxable benefit. In the case of a shareholder taxable benefit, the company will not get any deduction while the shareholder must show an income inclusion.

The CRA's change in policy is good news for a significant number of parents who were faced with a taxable benefit charge when their children enjoyed an employer-provided scholarship program.

I/R 2300.00

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Contributors to this issue of Comment:

James W. Kraft, CA, MTax, TEP, CFP, CLU, CH.F.C.
Deborah Kraft, MTax, TEP, CFP, CLU, CH.F.C.

Published by:

The Institute
390 Queens Quay West, Suite 209,
Toronto, Ontario M5V 3A2
T: 416.444.5251 or 1.800.563.5822
F: 416.444.8031
www.iafe.ca • info@iafe.ca

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