



COMMENT

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GOING PUBLIC

Shareholders take their company public for any number of reasons: to raise capital, to sell the business more easily, to attract top management, or a variety of other reasons. While income tax consequences are not a reason to go public, the company and its shareholders should consider advance-planning strategies to increase the effectiveness of the transition.

Company

From the company's point of view, several tax advantages will be lost and some will be gained when a company goes from private to public ownership status.

Capital Dividend Account ("CDA"). A public company cannot elect that a dividend be a capital dividend. Proper planning involves paying a capital dividend before going public if the CDA carries a positive balance.

Refundable Dividend Tax on Hand ("RDTOH"). A public company is not eligible for a refund of any refundable tax on hand. Therefore, ensure that sufficient taxable dividends are paid in order to clear the RDTOH. The RDTOH is refunded at the rate of \$1 for every \$3 of taxable dividends paid. In terms of timing, a company's RDTOH is only calculated at the company's year-end, so planning would involve clearing the account as at

the year-end prior to going public, or perhaps triggering a year-end before going public.

Small Business Deduction. A public company is not eligible for the reduced rate of tax on the first \$200,000 of active business income. Triggering a year-end just prior to going public allows the company to claim the small business deduction on active income earned during the period from the last year-end to the period just prior to going public. Note that the \$200,000 annual limit will be reduced pro-rata where the taxation year is less than 51 weeks.

Additional Refundable Tax. A public company is not liable for the extra 6.67 per cent tax on passive income earned by a Canadian-controlled private corporation ("CCPC"). This is good news because even though it is refundable, it can cause cash flow issues. Postpone the realization of any accrued capital gains; other types of passive income would have to be reported as earned. However, postponing a capital gain is not advisable if there is an intention to pay capital dividends and taxable dividends (to recover refundable taxes) out of the proceeds of sale.

Investment Tax Credits ("ITCs"). The federal government offers ITCs that reduce a corporation's federal income tax liability.

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However, a CCPC is eligible for additional credits, and it can claim a refund of credits in excess of its federal income tax liability. Trigger a year-end just prior to going public in order to maximize the amount and refundability of the investment tax credits.

Shareholders

Similar to the company, the shareholders will lose and gain on tax attributes when a private company becomes public.

Enhanced Capital Gains Exemption. This exemption is available to offset capital gains realized on shares of a qualified small business corporation. This means that shareholders of private companies going public have to take action in order to crystallize the value of the capital gains exemption. The Income Tax Act provides an election to allow shareholders in this situation to crystallize their capital gains

election. This election has to be made in respect of the year that the company goes from private to public.

Kiddie Tax. The “kiddie tax,” introduced in the 1999 federal budget, applies to minors who receive taxable dividends on shares of a private company. The minor has to pay tax on such dividends at the highest marginal tax rate, thereby eliminating the value of income splitting. Once the company becomes public, the kiddie tax will no longer apply. Take care to record whether the dividend was paid when the company was public or private.

Taking a company public may accomplish a number of objectives. Careful tax planning will ensure that valuable tax advantages are not lost and that new benefits are maximized.

I/R 2101

AVERAGE VERSUS MARGINAL TAX RATE

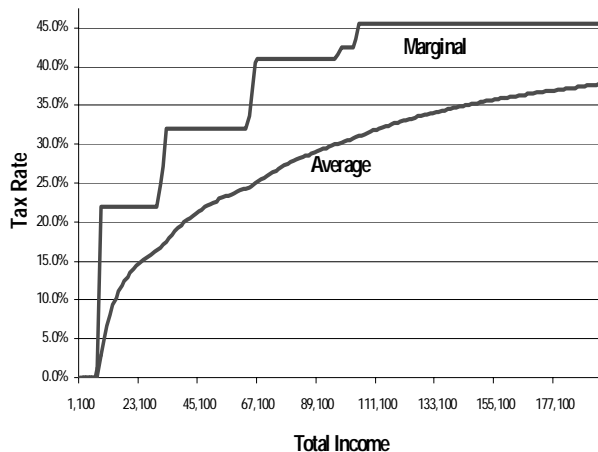
Financial planning often involves analysing various alternatives that can help you meet your objectives. If the analysis involves taxes, you should be familiar with the terms “marginal tax rate” and “average tax rate,” and when each might be most appropriately used. Using the wrong rate could render the analysis meaningless, and lead to an inappropriate decision.

The following graph illustrates the average and marginal tax rates using the 2002 federal tax rates and an assumed set of provincial rates. It assumes that the individual only qualifies for the basic personal non-refundable tax credit. The marginal tax rate jumps in a step pattern as the taxpayer moves into each successive tax bracket, and it levels off at the top bracket. The average tax rate results in an upward curved line because it reflects a moving average. It will approach the marginal tax rate line but never reach it.

Marginal tax rate

Almost everyone is familiar with the term “marginal tax rate.” This is the rate of tax applied to the next dollar earned. For high-income earners, the marginal tax rate aligns with the top tax bracket. For example, a person with more than \$103,000 of income is in the top federal and provincial tax bracket, and would therefore face the top marginal tax rate.

You would generally use the marginal tax rate if the strategy being considered would change your income by a reasonably small amount. For example, the after-tax cost of an RRSP contribution is normally determined using the marginal tax rate. However, caution should be exercised because the RRSP deduction may move you down to a different marginal rate. In that case, you must use different marginal rates for the appropriate portions of the RRSP deposit to get an accurate result.



Average tax rate

While most people know the amount of tax that they pay, seldom do they break it down into an average tax rate. Your average tax rate is simply equal to your total tax liability divided by total income. The rate of tax reflects your unique mix of income and tax credits. For example, a person who has \$110,000 of total income and pays \$33,000 of income tax has an average tax rate of 30 per cent. The corresponding marginal tax rate would be in the 40 to 45 per cent range, depending on the province of residence.

You would generally use an average tax rate if the strategy being considered would affect your total income significantly. The average rate is useful in an analysis that reflects all of the facts in the situation and not simply one contemplated transaction. If, for example, a taxpayer earning \$40,000 inherited money that would generate a substantial increase in future income, it would be appropriate to use the average tax rate for the new income level in any analysis.

When projecting retirement income cash flows, the average tax rate may be more appropriate than the marginal tax rate. After the pre-tax retirement income has been determined, income taxes should be estimated. The average tax rate should produce a better approximation.

Accuracy is needed in financial planning. Using the appropriate tax rate will produce more accurate results, allowing you to make more informed decisions.

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LENDING MONEY TO SHAREHOLDERS

Companies may lend money to employees as part of their benefit package. Subject to certain exceptions, the Income Tax Act defines the taxable benefit on such a loan as the difference between the prescribed interest rate and the interest rate that is charged to and paid by the employee. However, the general rule does not necessarily apply to employees who also happen to be shareholders of the company.

The Income Tax Act dictates that any loan to a shareholder (i.e., the principal amount) is taxable as income in the year it is received. However, the loan will not be taxable if it is repaid by the second year-end following the date of the original loan.

The Canada Customs and Revenue Agency (CCRA) administers this provision by including shareholder loans as income only if the loan is not repaid on time. (A special rule ensures that shareholders cannot repeatedly borrow and repay the funds to get around this rule.)

For example, a company with a December year-end could loan money to its shareholder in June of year one, and the loan could be outstanding on December 31 of year one with no income tax consequences (apart from a possible interest benefit). If the loan remains outstanding on December 31 of year two, the entire amount of the loan is taxable as income to the shareholder in year one. Therefore the previous year's tax return must be adjusted.

Upon the subsequent repayment of the loan, the shareholder can deduct from income any amount of loan principal that was previously treated as taxable.

The taxation of shareholder loans is softened with a short list of exceptions. If the loan is granted to the shareholder as an employee, and if bona fide repayment arrangements are made, a company can lend money to its shareholders for the purpose of buying a home, buying shares from treasury, or buying a vehicle that will be used in employment duties.

The current low prescribed interest rate and the exception for shareholder loans can create valuable planning opportunities for owners of private companies. The prescribed interest rate for the third quarter of 2002 is three per cent.

This means that a shareholder could borrow corporate money to buy a home, and arrange for the repayment of the loan with an interest rate of three per cent. Based on a 25-year amortization, the monthly payment would be about \$475 per \$100,000 of loan amount. The taxable benefit is calculated quarterly, comparing the rate of interest on the loan to the current prescribed rate or, in the case of a home purchase loan, the prescribed rate at the time the loan was granted (if lower). This means that if a home purchase loan is set up when the prescribed interest rate is three

per cent, a three per cent maximum limit is established for the first five years. It should be noted that a home purchase loan must renew at least every five years. At that time, the maximum prescribed interest rate is adjusted based on the prescribed rate in effect at the time of renewal.

A shareholder can also borrow money to buy a car, provided the car is required in the performance of employment duties for the company. The condition that the car must be "required" is significant because regular employees may borrow to fund the purchase of a car without a similar restriction. With the low current prescribed interest rates, borrowing to buy a car can be very advantageous compared to the standby and operating benefit charges that accrue for employees and shareholders with company-supplied vehicles.

A shareholder faces significant restrictions on accessing money in his or her company. And while a shareholder often is also an employee of the company, he or she cannot necessarily receive the same tax treatment for benefits as accorded to regular employees. In particular, loans can have significant income tax implications for shareholders.

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