The Owner Manager

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Anything New

YEAR END TAX PLANNING

It's hard to believe, but 1997 is almost at an end. With 1998 fast approaching, it's time again to look at year end tax planning tools. Any changes since last year? Let's take a look, and remember, prudent tax planning is a year round exercise.

The most popular of all tax planning vehicles is still the **registered retirement savings plan** (RRSP). Contributions made by March 1, 1998 are deductible in the 1997 taxation year. The maximum deductible contribution for 1997 (assuming no unused contribution room is carried forward from prior years) is $13,500. Check your 1996 notice of assessment for your RRSP contribution room for 1997. With interest rates still low, it makes sense to borrow from the bank for your RRSP contribution. Use your tax refund to pay down the bank loan. If you turn 69 or 70 in the year, remember to purchase either an annuity or a registered retirement income fund with your RRSP funds. Otherwise, the full value of the RRSP will be taxable in 1997. If you turn 65 in the year, you can purchase a $1,000 per annum annuity with a portion of your RRSP and qualify for the $270 pension tax credit available on pension income. The RRSP overcontribution limit is $2,000 before incurring penalties. A spousal RRSP may make sense for future income splitting and if your spouse is younger than you, it allows you additional years to make tax deductible RRSP contributions.

Goodbye 1997

Self-employed individuals caught in the 1995 change of year end rules must include 10% of their 1995 reserve income in their 1997 tax returns (assuming they have been following the tax department's minimum income inclusion rules).

If you are planning depreciable asset purchases for your business, do so before the year end of the business in order to claim some tax depreciation in the current year end of the business.

How long will the $500,000 capital gains exemption on the sale of small business company shares be around? No one knows, so you may want to consider crystallizing it, since it will reduce the tax on the eventual capital gain incurred when the shares are disposed of. Crystallization involves a corporate reorganization and ensuring you have the capital gains exemption available to shelter the capital gain created on the reorganization. The use of the capital gains exemption is affected by your cumulative net investment loss

Hello 1998

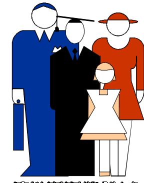
(See "year end" on back)

Something old, something new

ESTATE FREEZING

Those readers with excellent memories may recall that our second newsletter (September 1993) and our fifth newsletter (June 1994) both looked at the concept of "estate freezing/planning" under different scenarios. The growth of personal financial planning in the past few years has necessitated the use of some form of estate freezing. This article will review some old concepts and examine a new tax department position that will assist asset preservation through estate freezing.

As a refresher, estate freezing involves the exchange of growth shares of a corporation (usually common shares) for some form of frozen, non-growth shares (usually preferred shares) on a tax-free basis. The "freeze" is normally carried out as part of an estate plan to reduce the eventual capital gains taxes on death. In certain circumstances, it also allows for the ability to income split the corporation's income amongst the family members receiving common shares. However, carrying out an estate freeze can have repercussions in the area of family law.



You've been income splitting with your children for years through the family holding corporation. Now your 20 something child has announced that he and his girlfriend are getting married and a marriage contract is out of the question. You do not want some of the shares of the family holding company winding up in the hands of your child's spouse if the marriage breaks up. You also do not want the financial burden of paying your child's spouse 50% of the increase in value of the shares during the marriage if it dissolves. Is there a solution? Maybe.

Before the marriage, convert all of the existing common shares (including the common of the child about to be married) into non-growth preferred shares with a redemption value equal to the fair market value of the common shares. The conversion can be accomplished on a tax free basis. The articles of incorporation of the family holding corporation may have to be amended to create the required preferred shares. All of the previous common shareholders will be issued, pro-rata,

(See "estate freezing" on back)

("Year end" continued)

(CNIL) position and your allowable investment loss claims (ABIL). Check with your advisors before proceeding with any crystallization procedures.

Finding the proper dividend/salary mix of the owner/manager's income may be a consideration, depending on your circumstances. If you want to maximize your RRSP contributions, salary is the way to go. However, if you need to use your capital gains exemption and you have a CNIL problem, then dividends will do the trick. Remember, an individual with no other income can receive around $23,000 of dividends without paying any personal income tax. If the owner has loans to the corporation, he/she may want to consider charging interest on said loans. The interest is deductible to the corporation and taxable to the owner. However, interest on a loan does not attract payroll taxes and will reduce a CNIL balance if a capital gains exemption claim is being contemplated.

If you have capital gains in the year, you may want to sell capital property with unrealized losses to shelter the gain. Creating capital losses may be advantageous if you incurred capital gains in the 3 prior years, since capital losses can be carried back against them. However, if you attempt to create a loss by selling a capital property at a loss and then reacquiring the same or identical properties within 30 days, your capital loss will be denied by the superficial loss rules.

Examine your debt position. Are you paying non-deductible interest (personal type loans), yet you have business or investment assets earning income with no deductible interest expense as a shelter? Try and reorganize your affairs to pay down personal debt by replacing it with debt borrowed for the purpose of earning income.

Reasonable salaries paid to spouses and children for services provided is still an effective method of income splitting business income. Commissioned salespeople may also be able to pay a reasonable salary or fee to their spouse if their employer agrees by signing a T2200 form (statement of employment conditions).

Recent Tax Cases

The "**No Expectation of Profit test**" continues to be a major argument by the tax department in challenging business and rental loss claims of taxpayers. And they are having considerable success.

In the **Mastri et al** case, the taxpayers acquired and temporarily rented their principal residence for a short term. The residence was heavily mortgaged and therefore the taxpayers incurred rental losses. The tax department successfully denied these rental losses on appeal to the Federal Court of Appeal using the no expectation of profit test.

In the **Heier** case was one where the taxpayer operated a bookstore selling religious books. Her business losses were disallowed by the tax department. The tax department successfully argued that the taxpayer had no expectation of profit since her markup was unrealistically low and her intentions were to propagate the faith.

Finally, in the **Lorenz et al** case, the principals were involved in the arranging of the publication of a magazine. License fees, professional fees and other expenses were paid by the taxpayers. However, the taxpayers never actually engaged themselves in the publishing business. The tax department successfully disallowed the losses incurred from the publishing business arguing that the arrangement was simply a tax reduction scheme with no reasonable expectation of profit. ✍

("Estate freezing" continued)

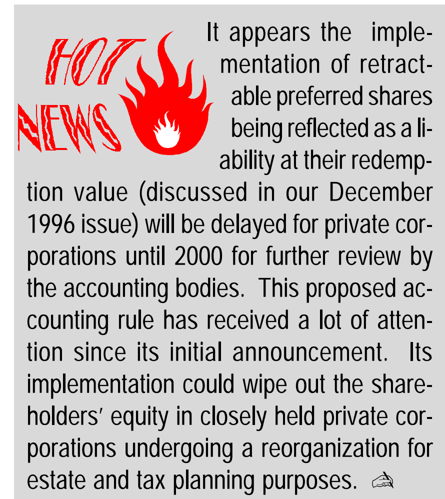
new common shares for nominal consideration except the child about to be married. Since all of the value of the "old" common shares are now in the newly issued preferred shares, the new common can be issued at any price without triggering any adverse tax consequences. Issue yourself, pro-rata, the new common representing the about to be married child's interest in the corporation.

After the marriage, gift the common shares using a deed of gift to your newly married child. Because the conversion of the old common to preferred and the gifting of the new common happens within a short time span, there should be no significant increase in value of the new common shares, thus no capital gain on the gift. In the deed of gift, specifically exclude the common shares and any income thereon as net family property of your newly married child. Now, if the marriage breaks up, any growth in the common shares owned by the married child should be excluded as net family property of your child in the divorce.

And now for some good news in the area of estate freezes. Because of the recession in the first half of the 90's, taxpayers who had carried out estate freezes involving real estate assets which subsequent to the freeze declined in value, found themselves owning preferred shares worth less than their redemption value. The tax department's long standing position was that any attempt to reduce the redemption value of the preferred shares to reflect the decline in value of the real estate would result in a taxable benefit to the shareholders. This position has now been reversed. The tax department is now of the opinion that no taxable benefit will occur in a "refreeze" of preferred shares under the following circumstances:

- the existing preferred shares are exchanged on a tax deferred basis for a new class of preferred shares with a redemption value reflecting the current fair market value (a lower value) of the preferred shares, and
- the decrease in value of the preferred shares is not the result of the stripping out of corporate assets by the shareholders.

Taxpayers who executed estate freezes in the 80's may want to re-evaluate the fair market value of their preferred shares to see if a refreeze is in order. ✍



It appears the implementation of retractable preferred shares being reflected as a liability at their redemption value (discussed in our December 1996 issue) will be delayed for private corporations until 2000 for further review by the accounting bodies. This proposed accounting rule has received a lot of attention since its initial announcement. Its implementation could wipe out the shareholders' equity in closely held private corporations undergoing a reorganization for estate and tax planning purposes. ✍

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