Turning Tax Changes into Tax Savings

Tim Cestnick, FCA, CPA, CFP, TEP

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Where We're Going

- Income splitting
- Eligible Dividends
- Registered Retirement Savings Plans
- Registered Education Savings Plans
- Lifetime Capital Gains Exemption

Where We're Going

- Private Foundations
- Court Decisions
  - GAAR decisions
  - Corporate owned insurance
  - Holograph wills

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Income Splitting

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Income Splitting

- Eligible pension income may be transferred to spouse
- Up to 50% of eligible income can be transferred
- Eligible income: Income that qualifies for the pension credit;
  - 65 or older: lifetime annuity payments under an RPP, RRSP, DPSP, or RRIF
  - Under 65: lifetime annuity payments under an RPP and certain other payments received as a result of the death of your spouse or common-law partner.

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Income Splitting

- Deduction will be available to transferor spouse
- Transferee spouse adds amount to income
- Question: will transferred amount qualify for pension credit in hands of transferee spouse? I expect so
- How much tax will this save? Consider a common scenario

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Income Splitting

- Husband has $60,000 of taxable income; $50,000 is eligible pension income
- Wife has $10,000 of income
- Husband allocates 50% of pension income, or $25,000 to his wife
- Couple will save $4,196 in 2006 (Ontario tax rates)
- Amount saved = 7% of income

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Income Splitting

Before Income Splitting

	Husband	Wife	Total
Pension Income	$ 50,000.00	$ -	$ 50,000.00
Other Income	$ 10,000.00	$ 10,000.00	$ 20,000.00
Total Income	$ 60,000.00	$ 10,000.00	$ 70,000.00
Income Taxes Before Pension Credits[1] and Age Credits[2]	$ 13,302.23	$ 177.05	$ 13,479.28
Pension Credits	$ 375.00	$ -	$ 375.00
Age Credits	$ -	$ 177.05	$ 177.05
Net Tax Owing	$ 12,927.23	$ -	$ 12,927.23

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Income Splitting

After Income Splitting

	Husband	Wife	Total
Pension Income	$ 25,000.00	$ 25,000.00	$ 50,000.00
Other Income	$ 10,000.00	$ 10,000.00	$ 20,000.00
Total Income	$ 35,000.00	$ 35,000.00	$ 70,000.00
Income Taxes Before Pension Credits[1] and Age Credits[2]	$ 5,607.75	$ 5,607.75	$ 11,215.50
Pension Credits	$ 375.00	$ 375.00	$ 750.00
Age Credits	$ 867.37	$ 867.37	$ 1,734.74
Net Tax Owing	$ 4,365.38	$ 4,365.38	$ 8,730.76

Tax Savings:
$4,196

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Eligible Dividend Strategies

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Eligible Dividends vs. Bonus

Ontario Tax Rates

Integration Under New Dividend Rules
Bonus v. No Bonus

		2007 Bonus	2007 No Bonus
Taxable income of corporation		1,000,000	1,000,000
Bonus		(600,000)	
Taxable income after bonus	A	400,000	1,000,000
Total low-rate corporate income tax	B	74,480	74,480
Total general-rate corporate income tax	C	-	244,722
Total corporate income tax	D = B + C	74,480	319,202
Personal tax on bonus (excluding EHT)	E	278,400	-
Total personal and corporate tax before dividends	F = D + E	352,880	319,202
Deferral from not paying bonus		-	33,678
Cash available for dividend	G = A - D	325,520	680,798
Dividend Pools:			
Eligible		-	355,278
Non-Eligible		325,520	325,520
		325,520	680,798
Personal Income Tax:			
Eligible dividend		-	87,540
Non-Eligible dividend		102,213	102,213
Total personal tax on dividends		102,213	189,753
Total personal and corporate income taxes		455,093	508,955
Absolute tax savings (cost) from paying bonus			53,862
Years for deferral to make sense rather than bonus:			
	5%		15.4
	10%		7.9
	15%		5.4
	20%		4.1

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Eligible Dividends vs. Bonus

Ontario Tax Rates

Integration Under New Dividend Rules
Bonus v. No Bonus

		2010 Bonus	2010 No Bonus
Taxable income of corporation		1,000,000	1,000,000
Bonus		(600,000)	
Taxable income after bonus	A	400,000	1,000,000
Total low-rate corporate income tax	B	66,000	66,000
Total general-rate corporate income tax	C	-	226,002
Total corporate income tax	D = B + C	66,000	292,002
Personal tax on bonus (excluding EHT)	E	278,400	-
Total personal and corporate tax before dividends	F = D + E	344,400	292,002
Deferral from not paying bonus		-	52,398
Cash available for dividend	G = A - D	334,000	707,998
Dividend Pools:			
Eligible		-	373,998
Non-Eligible		334,000	334,000
		334,000	707,998
Personal Income Tax:			
Eligible dividend		-	83,701
Non-Eligible dividend		104,876	104,876
Total personal tax on dividends		104,876	188,577
Total personal and corporate income taxes		449,276	480,579
Absolute tax savings (cost) from paying bonus			31,303
Years for deferral to make sense rather than bonus:			
	5%		(5.4)
	10%		(2.7)
	15%		(1.9)
	20%		(1.4)

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Income Splitting

- Can sprinkle “eligible” and “non-eligible” dividends to different classes of shares
- Tax-free dividends of over $45,535 can now be paid out (federally)
- Alternative Minimum Tax (AMT) can be a problem now

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Income Splitting

- Can avoid need for separate classes of shares if you use a family trust to distribute dividends to beneficiaries
- Where GRIP exists, pay eligible dividends to higher income shareholders
- Where GRIP exists, avoid paying eligible dividends to: non-residents, lower income shareholders, and where other deductions are used to reduce income (i.e. RRSP, flow throughs, etc.)

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Investment Holding Companies

- There can be a tax cost (prepayment of tax) to hold Canadian public company shares in a holding company
- Part IV tax rate = 33.33% (eventually refunded, but a prepayment until that time)
- Personal tax rate on eligible dividends down to 22.38% in Ontario…approx. 11% prepayment of tax in Ontario
- Over 19% prepayment of tax in Alberta

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Investment Holding Companies

- Consider paying eligible dividends out of corporation annually to avoid prepayment (that is, use RDTOH to remove investments from holding companies to be reinvested personally instead…more tax efficient)
- But consider: (1) availability of losses inside corporation, (2) OAS clawbacks, (3) U.S. estate taxes (for U.S. securities), (4) desire to freeze, (5) income splitting, (6) tax and other costs of moving investments

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Asset Protection

- Can transfer investments to a trust or a spouse to protect assets from creditors (count tax cost if transferring to a trust)
- Attribution rules may apply after transfer
- If dividends subject to attribution, they retain their character as eligible. So, transfers to trusts or spouses can be done for asset protection without additional tax cost

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Registered Retirement Savings Plans

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Registered Retirement Savings Plans

- Maturity date has been moved from 69 back to 71 again, starting in 2007
- Withdrawals from RRIF must start in year client reaches age 72, starting in 2007
- What does all of this mean?

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Registered Retirement Savings Plans

- Age 69 or younger in 2007:
  - can keep RRSP around additional two years
- Age 72 or older in 2007:
  - no benefit to you

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Registered Retirement Savings Plans

- Age 70 or 71 in 2007:
  - can convert a RRIF back to an RRSP (likely makes little sense)
  - can open a new RRSP (makes sense if unused contribution room or sufficient earned income in 2007)
  - minimum required withdrawal will be waived in 2007 and 2008 if age 70 in 2007 (waived for 2007 if age 71 in 2007)
  - annuity: can defer payments until year you reach 72

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Registered Education Savings Plans

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Registered Education Savings Plans

- Can now contribute up to $50,000 in a lifetime in respect of a beneficiary
- Full $50,000 can be contributed at any time ($4,000 annual limit has been eliminated)
- Does it makes sense to stagger contributions over time to take advantage of CESGs, or contribute the maximum today?

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Registered Education Savings Plans

- Example:
- Hatfields:
  - Baby born in 2007
  - Contribute $50,000 to RESP in 2007
  - CESGs of $500 paid into plan in 2007
  - Plan will have $201,799 at end of 18 years, assuming an 8% annual return

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Registered Education Savings Plans

- Example:
- McCoys:
    - Baby born in 2007
    - Contribute $50,000 over next 18 years ($2,778 annual contribution)
    - CESGs of $7,200 paid into plan over the years
    - Plan will have $130,422 at end of 18 years, assuming an 8% annual return

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Lifetime Capital Gains Exemption

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Lifetime Capital Gains Exemption

- Total exemption has been increased from $500,000 to $750,000
- Available to shelter capital gains on:
    - Qualified Small Business Corporation Shares
    - Qualified Farm Property
    - Qualified Fishing Property

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Lifetime Capital Gains Exemption

- The value of the exemption if fully utilized:
  - When it was $500,000 = $116,000
  - Now that it is $750,00 = $174,000

  (Ontario tax rates)
- Realize that these may be future tax savings (i.e. when sell shares or die)…so present value of the tax savings might be much less
- Still, can be worth crystallizing the exemption

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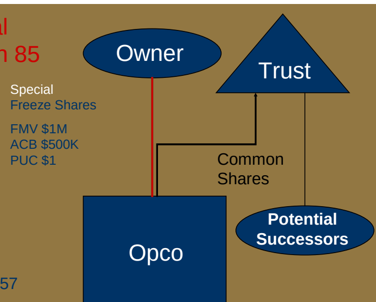
The Estate Freeze

Internal
Section 85



Notes:

1. Can choose selling price

2. Partial freeze (a GEL) is possible

3. Must fileT2057 election

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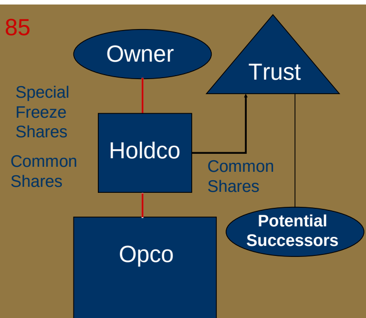
The Estate Freeze

Section 85
Holdco



Notes:

1. Best if other s/h don't want to freeze

2. Holdco can control timing of dividends

3. Must file T2057 election

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Private Foundations

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Donation of Securities

- Federal budget of May 2, 2006
  - Eliminated capital gains on donation of publicly traded securities
- Federal budget March 19, 2007
  - Extended treatment to private foundations
- Scenario: donor may want to sell a particular security, but no desire to donate full proceeds to eliminate tax

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Donation of Securities

- Example:
- Donor owns shares in XYZ Corp. worth $100,000 and ACB of $50,000
- Donor wants to sell XYZ Corp.
- No desire to donate full amount of securities to charity
- If donor sells, triggers tax of $11,500 (marginal tax rate of 46%)
- Cash in hand, after taxes = $88,500

Donation of Securities

- Idea:
- Donor can donate $20,000 worth of XYZ shares to charity, then sell the balance worth $80,000
- Results:
- $9,200 in tax on $80,000 worth of shares sold
- No tax on shares donated to charity
- Donation tax credit of $9,200 from donated shares

Donation of Securities

- Cash in hand after the donation (no taxes) = $80,000
- How much cash did donor give up due to donation?
  - $8,850 ($88,500 - $80,000)
- How much does charity receive?
  - $20,000
- This is a “charitable arbitrage opportunity”

Donation of Securities

- Example:
- Donor owns shares in XYZ Corp. worth $100,000 and ACB of $50,000
- Donor wants to sell XYZ Corp.
- No desire to donate full amount of securities to charity
- If donor sells, triggers tax of $9,750 (marginal tax rate of 39%)
- Cash in hand, after taxes = $90,250

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Donation of Securities

- Idea:
- Donor can donate $20,000 worth of XYZ shares to charity, then sell the balance worth $80,000
- Results:
- $7,800 in tax on $80,000 worth of shares sold
- No tax on shares donated to charity
- Donation tax credit of $8,317 from donated shares

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Donation of Securities

- Cash in hand after the donation (no taxes) = $80,517
- How much cash did donor give up due to donation?
  - $9,733 ($90,250 - $80,517)
- How much does charity receive?
  - $20,000
- This is a “charitable arbitrage opportunity”

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Donation of Securities

- How to determine the amount to give to charity:

$$\text{Donation} = \frac{(\text{FMV})(\text{FMV} - \text{ACB})}{(3\text{FMV} - \text{ACB})}$$

Donation of Securities

- How to determine the amount to give to charity:

$$\text{Donation} = \frac{(\$100{,}000)\ (\$100{,}000 - \$50{,}000)}{(3)(\$100{,}000) - (\$50{,}000)}$$

$$= \$20{,}000$$

- Formula is approximate in some provinces

Donation of Flow-Through Shares

Donation of Flow Through Shares

- Flow through shares present a special opportunity
- Company agrees to incur Canadian Exploration Expenses and Canadian Development Expenses on your behalf
- Amount of expenditure equals amount you invest in the shares
- Company agrees to renounce and flow through these deductions
- Deduction often comes over two or three years
- ACB of the shares is zero

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Donation of Flow Through Shares

- Example:
- $10,000 investment in flow through shares
- Tax deduction saves taxes of $4,600
- Donation of shares to charity after the development is done
- Assume shares are still worth $10,000
- No tax on capital gain on donation to charity
- Tax credit for $10,000 donation saves taxes of $4,600

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Donation of Flow Through Shares

- Result:
- Total tax savings of $9,200 ($4,600 + $4,600)
- Out-of-pocket cost = $800 ($10,000 - $9,200)
- Benefit to charity = $10,000
- An even greater charitable arbitrage opportunity

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Various Court Decisions

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General Anti-Avoidance Rule

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GAAR

- General Anti-Avoidance Rule (GAAR) criteria has been clarified by two recent Supreme Court of Canada decisions:
- *Canada Trustco Mortgage Co. v. Canada* (2005 SCC 54)
- *Mathew v. Canada* (2005 SCC 55)
  - Mathew: The Minister was able to show that allowing the tax benefit obtained by the taxpayer in his situation would be inconsistent with the object, spirit or purpose of the provisions of the Act that the taxpayer relied upon.
  - In the Canada Trustco case, the Minister failed to show this

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GAAR

- Three conditions must be met for GAAR to apply

1. There must be a tax benefit from the transaction(s)
2. Must be an "avoidance" transaction in the sense that it was not arranged primarily for bona fide purposes, other than to obtain a tax benefit. This doesn't mean that there must necessarily be a business purpose for the transaction(s), but there should be some purpose beyond gaining a tax benefit
3. Transaction(s) must be abusive. That is, allowing the tax benefit would be inconsistent with the object, spirit, or purpose of the provisions of the Act relied upon by the taxpayer.

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GAAR

- Burden is on the taxpayer to refute the first two principles in each case.
- The onus, however, is on the CRA to establish the third principle – that the avoidance transaction was abusive.

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Lipson

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Lipson

- W borrowed money to aquire shares from H in FamilyCo
- Couple used proceeds to purchase home
- They took out mortgage on home and paid off share loan
- CRA disallowed interest deduction; Court sided with CRA
- Court applied GAAR
- Does GAAR override the "direct use" test established in Singleton case?
- Have sought leave to appeal to Supreme Court

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Reakes

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Reakes

- Corporation purchased a life insurance policy on R's life
- Wife was the beneficiary of the policy
- Corporation deducted premiums
- CRA disallowed deduction for premiums: makes sense
- CRA assessed a taxable benefit on R for amount of premiums paid on the policy
- Court sided with CRA

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Reakes

- Can avoid similar fate:
  - Name corporation as beneficiary of policy to avoid taxable benefit equal to premiums paid
  - Pay salary sufficient to cover insurance premiums (deductible to corporation) and then purchase the insurance personally instead

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Atherton

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Atherton

- Atherton had two sons and 11 grandchildren
- A's will left 2/3 of estate to Son # 1 and last 1/3 to grandchildren equally
- A changed his mind three days before his death
- He had handwritten instructions to leave his home to Son # 2
- He asked his grandaughter C to type up his new wishes so he could sign it, and asked a family friend to attend as a witness
- C went away and typed up wishes as requested

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Atherton

- The next day, C returned with the typed document
- A whispered in her ear: "Everything is fine"
- A died the next day without having signed the document
- Issue: Were the handwritten notes a testamentary document (i.e. a valid will)
- Holograph wills are valid in some provinces

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Atherton

- Not every handwritten note will be considered a valid will
- Requires an intention to be a testamentary document
- If deceased believed the document required witnesses to be effective, the court will not find the handwitten document to be a valid will
- Atherton case: A believed a witness was required to witness his signature, and this didn't take place

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Atherton

- Moral of the story:
  - Problems with holograph wills:
    - was decedent under duress?
    - intentions could be confusing
    - tax planning is generally ignored
    - writing may be illegible
    - could be altered by someone
    - pay a lawyer to get it done right!

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contact us

The WaterStreet Group Inc.
5500 North Service Road
Tenth Floor
Burlington, Ontario
L7L 6W6

T 905.332.4455
T 1.877.974.7687
F 905.332.5955
E tcestnick@waterstreet.ca
w www.waterstreet.ca