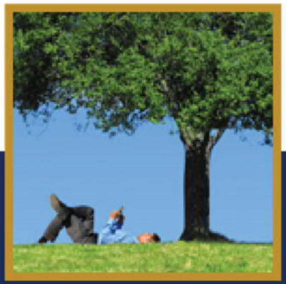
Bateman MacKay
CPAs and Business Advisors

Planning and Opportunities in Difficult Times

May 5, 2021





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Agenda

- Current Environment
- Estate Freeze
  - Planning
  - Prescribed rate Loan
- Holding companies
  - Active Vs Passive Income
- Loss Utilization
  - Inter Vivos Pipeline



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Estate Freeze

Initial Incorporation

- 100 shares issued to entrepreneur, at nominal value
- The shares encompass both votes and value
- If the succession plan does not involve the entrepreneur’s family
  - the shares can be easily sold to another entrepreneur (business partner or third party), during the entrepreneur’s lifetime or upon death
  - the entrepreneur may be able to use the capital gains exemption



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Estate Freeze

Initial Incorporation

- But if the succession plan involves the entrepreneur's family
  - it is not so easy to sell or give the shares to one or more family members, either during the entrepreneur's lifetime or upon death
  - sale: where do the purchase funds come from?
  - Gift: how do other family members receive fair financial treatment?
- are there other estate assets that can be distributed to other family members?
- Is there life insurance in place to fill any gaps?



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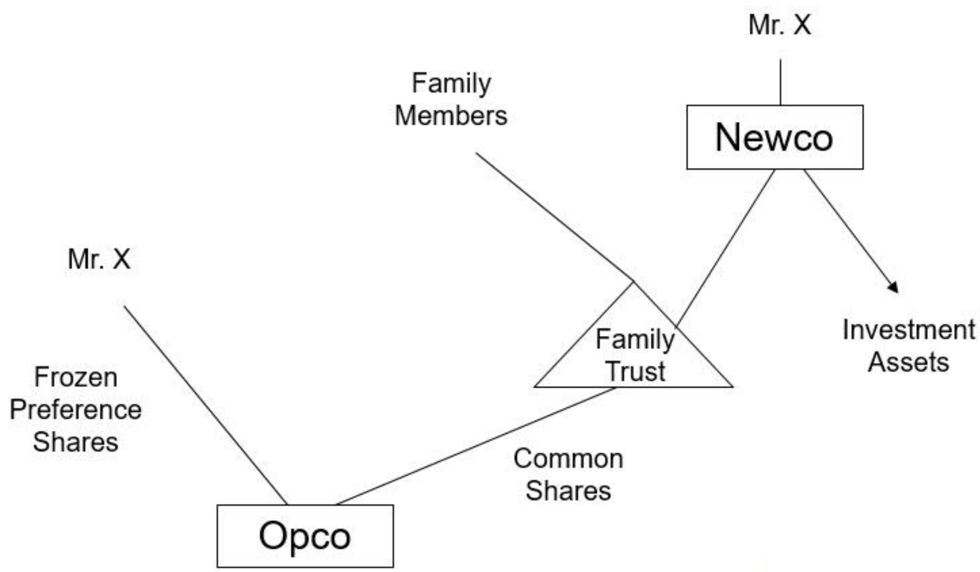
Estate Freeze
The Contemporary Holdco Illustrated



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Estate Freeze Planning

- Reorganize share structure of company
  - Common Shares (“Children”)
  - Preferred Shares (“parents”)
  - Special shares(“Planning”)
- Growth of the company is passed on to the next generation
- Multiplication of LifeTime Capital Gain Exemption. $892K
- Retirement planning by creating a “wasting Freeze”
  - Redeemed over time as retirement income

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Estate Freeze Planning

- Family Trust
  - Estate Planning
  - Multiply Capital Gains Exemption
  - Prescribed rate loan
- Holding Corporation
  - Retirement Company
  - Investments, Capital gains Vs Interest and Dividends.
  - 50K limit prior to ground down to 150K



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Prescribed Rate Loan Trust

- Vehicle for income splitting with other family members including minors
- Current valuations are low allowing for more tax savings on future upside by allocating future gains and investment income to family members in lower tax brackets
- Prescribed interest rate will drop to 1% in July 2020



Prescribed Rate Loan Trust

Example:

Invested assets - $750,000

ROI – 5%

Investment income - $37,500

(assume maximum tax rates)

	Earned in company		Parent	Children via PRL Trust
Investment income	37,500	Investment income		37,500
Tax rate (net of RDTOH)	19.5%	Interest @ 1%	7,500	(7,500)
Tax	$7312			
Available for distribution	$30,188	Taxable income	$7,500	$30,000
Personal tax rate	39.34%	Personal tax rate	53.53%	0%
Personal tax	$11,875	Personal tax	$4,015	$ 0
Total tax	$19,187	Total Tax	$4,015	$0
Cash after tax	$18,313	Cash after tax	$3,485	$30,000

Active Vs Passive Income in a corporation

- Active Business Income (ABI)
- Passive Income
  - generated from investments

Investment income is treated very differently than business income for tax purposes



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Active Vs Passive Income in a corporation

- What is passive investment income?
  - "Aggregate investment income" includes interest, rent, royalties, foreign dividends, net taxable capital gains, including distributions from mutual funds, ETFs, etc.
  - Taxed at a high corporate tax rate on every dollar
- What does investing passively mean?
  - Tax deferral on business income set aside in the corporation and invested for personal savings
- Refundable Dividend Tax On Hand "RDTOH"
  - High corporate taxes include a non-refundable component and a refundable component
  - RDTOH represents the refundable component refunded when a taxable dividend is paid to shareholder



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Passive Income in a corporation

- Small business limit will be reduced when passive income exceeds $50,000
- $500K small business limit reduced by $5 for every $1 of investment income above $50,000
- Small business limit reduced to $0 once passive income exceeds $150,000
- New concept of “adjusted aggregate investment income” used to calculate reduction in the small business limit. This includes, but is not limited to;
- Rent, Interest, foreign income, taxable capital gains & eligible dividends

Consider Corporate Class investments



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Capital Gains and the Capital Dividend Account (CDA)

- The CDA is a “notional” account which accumulates the non-taxable receipts of a corporation – for example
  - the non-taxable portion (50%) of capital gains
  - life insurance (net of the ACB)
  - Distributions to shareholders from the CDA are tax-free ‘capital dividends’
  - Timing of a CDA is key, as it happens on the exact date, not Year end.

Focusing on capital gains increases the CDA! – Great source of Retirement Cash Flow!



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Loss Utilization - Overview

- Objective of loss utilization is to utilize existing realized or unrealized non-capital or capital losses to shelter future or past tax liabilities
- Can take place at either the personal or corporate level
- Can sometimes be accomplished with little effort; otherwise, may require some additional steps or potentially even a corporate reorganization
- Income Tax Act has broad specific anti-avoidance rules to curtail loss trading between arm's length parties



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Loss Utilization – Personal Non-Capital & Capital Losses

- Non-capital losses carry forward 20 years and carry back 3 years.
- Easiest to utilize as they can offset any type of income
- Capital losses much more problematic as only utilized against capital gains
- Capital losses carry forward indefinitely and can be carried back 3 years



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Loss Utilization –
Alternatives for Personal Capital Losses

- Once realized, first look for prior capital gains or other unrealized capital gains on other capital properties
- Unrealized gains – consider realizing them
- Is loss derived from an "adventure or concern in the nature of trade"?
- If there is a company (incl. holding company) owned by the taxpayer, there is a corporate reorganization to extract "capital gains" from the company to offset capital losses
- Consider flow-through shares and/or other leveraged tax shelters that generate current non-capital losses and a future capital gain – BUYER BEWARE



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Loss Utilization – Corporate Losses

- Where 1 Corp in an affiliated group is profitable (Profitco) and another is losing money (Lossco)
- Absent any planning, may be problematic from a cash flow perspective due to Profitco’s tax liability
- CRA actually can be sympathetic to bona fide, legitimate loss utilization strategies



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Inter vivos Pipeline

- Extract funds from corporation at a more effective tax rate
  (potential tax savings of up to approx. 21%)
- Tax implications:
  - Trigger corporate capital gains on accrued investment gains
    (no implications if cash vs. shares)
  - Personal capital gains on extraction of funds
- Currently lower portfolio valuations
- Currently lower over all corporation valuations

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Inter vivos Pipeline

Example:

Cash in corporation - $1,000,000

Requirement that must be met:

- Company continues to operate a business and is not wound up after the transaction or else capital gains can be converted to dividend

	Dividend	Capital gains
Cash	1,000,000	1,000,000
Personal tax rate	47.74%	26.76%
Personal tax	$477,400	$267,600
Cash available for reinvestment	$522,600	$732,400



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Loss Utilization – The “Management Fee”

- Lossco charges Profitco management fee
- Numerous areas of exposure:
  - Retroactive tax planning?
- Management fees reasonable under the circumstances?
- Management services agreement?
- Any management personnel in Lossco?
- Degree of integration of Lossco and Profitco’s operations?
- GST and whether both entities are GST registrants?
  - Better alternative may include a review of intercompany charges/transfer pricing
- If pursuing this alternative, should at least transfer management personnel to Lossco, establish a reasonable basis for management fees, apply it consistently throughout the year and enter into a management services agreement



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Loss Utilization – Amalgamations

- Involves two predecessor corporations merging to form a new corporation (Amalco)
- Simple & straightforward
- Accomplished tax deferred
- Amalco deemed a continuation of predecessor corporations (incl. its loss pools)
- Losses of Amalco cannot be used to be carried back to predecessor corporations' income
    - Exception: where wholly-owned sub and parent amalgamated, can carry back parent's losses to parent's income
- Planning point: where 2 sister companies, consider transferring shares of one sister co to another to create parent-subsidiary relationship then amalgamate
- Post amalgamation, Amalco can determine its new taxation year-end.
- The "bump": ability to increase adjusted cost base of non-depreciable capital property (i.e.: common shares, land) to their FMV



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Loss Utilization – Amalgamations (Cont'd)

Before Amalgamation

Shareholder

Corp A

Corp B

After Amalgamation

Shareholder

Corp AB

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Loss Utilization – Wind-ups

- Similar to amalgamations except tax-deferred wind-ups are reserved for parent corporations and wholly owned subsidiaries
- Key difference: parent survives and not deemed to cease to exist
- Loss pools of subsidiary's become part of parent's loss pools to be utilized
- Where both parent/sub have identical year-ends – same tax implications between amalgamation and wind-up
- Where parent has different y/e than sub, parent utilizes losses in tax years after commencement of wind-up
- However, tax election available to accelerate the loss utilization by one year



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Loss Utilization – Amalgamations (Cont'd)

Before Wind-up

Shareholder

Parent

Sub

After Wind-up

Shareholder

Parent

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Loss Utilization – Amalgamation or Wind-ups: Practical Constraints

- Potential creditors of former corporations can now attach themselves to assets of combined entity
- Accounting systems may need consolidation as well
- For Amalco, need new business numbers and other identification numbers



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Loss Utilization – Refinancing Profitco

- Refinancing Profitco comprises of the following steps:
  - Lossco obtains a daylight loan and makes a loan to Profitco
  - Profitco in turn subscribes for shares in Lossco
  - Lossco repays daylight loan
  - Lossco charges Profitco a reasonable rate of interest
- Issues:
  - Terms and types of shares subscribed by Profitco
  - Can Lossco obtain the daylight loan without any other entity’s guarantee?
  - Lossco and Profitco cross-creditor exposure up to amount of refinancing
  - What is a reasonable interest rate?



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Loss Utilization – Transferring a Profitable Business Line

- Profitco transfers a profitable business line to Lossco and the profitable business's future profits sheltered with Lossco's losses
- Transfer can be implemented tax-deferred
- Major Issue: Maintaining commercial and legal substance to the transaction
  - Actually transferring employees
  - Advising suppliers/customers/landlords/insurance, etc.
- Profitable business line exposed to Lossco creditors (incl. unforeseen creditors)



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Loss Utilization – Transferring Assets With Unrealized Gains

- Profitco transfers a specific asset with unrealized gains to Lossco on a tax-deferred basis and Lossco subsequently disposes of asset to 3rd party
- CRA allows this transaction administratively only for affiliated corporations
- “Affiliated”: Corp A and Corp B under common control or Corp A controlled by spouse of Corp B
- Otherwise the Act contains a specific anti-avoidance rule to circumvent loss trading between arm’s length parties



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Loss Utilization – Other Techniques and Tips

- Restrict claims for capital cost allowance

- Lossco leases assets to affiliated Profitco

- Sale of assets to Profitco for FMV promissory note



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Questions?

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