

# Newsletter

## FALL 2011

### RRSPs and Private Company Shares

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The reintroduced Federal Budget includes new anti-avoidance measures designed to address aggressive use of Registered Retirement Savings Plans (RRSPs) in tax planning schemes. The new rules may prohibit private company shares from being “qualified investments” for RRSP purposes. You could now face a tax equal to 50% of the fair market value of previously qualifying investments, unless they are disposed of in a timely manner.

#### Old Rules

The previous rules permitted private company shares to be qualified for RRSP purposes if at the time the RRSP acquired the shares:

1. The annuitant and related parties owned, directly or indirectly, less than 10% of the issued shares of any class of the capital stock of the corporation or of any related corporations;
- OR
2. Where the ownership is 10% or more, the annuitant and related parties do not control the company and the total cost of all shares held in the corporation or any related corporation is less than \$25,000.

#### New Rules

Under the new rules, holding shares which only qualified under the second condition listed above will now result in a “prohibited

investment” for RRSP purposes. A 50% tax will apply to the annuitant if the RRSP fails to dispose of the prohibited investment prior to December 31, 2012.

In order to avoid the tax liability, the annuitant will be able to swap cash or other property with equivalent value until December 31, 2012. An appropriate valuation of the private company shares will be required to support the transaction.

#### Example

A \$10,000 investment in an RRSP made ten years ago to start a business with four other unrelated partners has now grown in value to \$1,000,000. At the time of the investment it would have been a qualified investment with 20% control of the private corporation. Under the new rules, the investment would be deemed prohibited as ownership of the corporation is over 10%. If the shares are not disposed of prior to December 31, 2012, the tax liability will be \$500,000.

#### Recommendations

In order to mitigate the tax consequences of the new rules, any private company shares held in an RRSP should be reviewed as soon as possible to ensure they have not become prohibited investments, and to allow sufficient time for disposal if necessary.

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“Either you decide to stay in the shallow end of the pool or you go out in the ocean.”

—CHRISTOPHER REEVE  
Actor

#### Special points of interest:

- Consider withdrawing funds from your RESP now so that you are taxed in 2011 to use the tuition tax credit.
- 3-year capital loss carryback, if you are considering realizing some losses.
- Personal tax instalments:
  - December 15, 2011
  - March 15, 2012
  - June 15, 2012
  - September 15, 2012

## Benefiting from the Capital Gains Exemption Without Selling Your Business

When selling a business, tax advisors will suggest utilizing the capital gains exemption to shelter some or all of the resulting tax. Since 1986, the capital gains exemption has been a “tax windfall” to the small-business owner, as it allows the tax-free receipt of up to \$750,000 in capital gains on the sale of qualifying shares. However, business owners should consider taking advantage of the exemption long before the eventual sale of their business.

A shareholder of a corporation could exchange their shares for new shares. All, or a portion of the inherent gain, is realized with the resulting capital gain sheltered by the shareholder claiming the capital gains exemption on their personal tax return. This is known as “triggering” or “crystallizing” the exemption. Shareholders who originally had little or no tax cost on the shares of their company will often be left holding new shares with up to an additional \$750,000 in tax cost.

Some of the reasons to crystallize the capital gains exemption are:

1. **Shares may not qualify in the future** – Eligibility requirements to qualify for the exemption are complex, including:
  - a) 90% or more of the value of the assets of the corporation must be used in an active business at the time of the share sale.
  - b) The corporation must meet a similar test throughout the previous 24 months with the business asset percentage reduced from 90% to 50%.
  - c) The shareholder, or a related person, must have held the shares throughout the previous 24 months.

Given these strict eligibility requirements, shareholders are wise to take advantage of the exemption while the shares qualify. If not, shareholders may end up with non-qualifying shares at the time an offer is received. Some shares will not be eligible for up to two years if the requirements in b) or c) are not met.

2. **Ensuring eligibility before a buyer comes knocking** – To meet requirement a) above, non-business assets such as portfolio investments, rental properties or excess cash must often be removed

from the company. This is referred to as “purifying” the company. The non-business assets are typically transferred to a “sister company.” However, the transfer of the assets may not be possible on a tax-free basis if the transfer is part of the same series of transactions as the sale of the shares to an arm’s-length purchaser. Triggering the exemption far in advance of the sale may avoid the tax.

3. **Cheap form of life insurance** – Many shareholders ignore the crystallization process because they believe a sale is highly unlikely or their industry is better suited to a sale of assets. However, a “stepped-up” tax cost on shares can result in a reduced tax liability on a shareholder’s death.
4. **Tax basis is always valuable** – Rules exist to prevent shareholders from utilizing the capital gains exemption to extract money from the company on a tax-free basis. However, those rules don’t always apply. For instance, if shares were acquired prior to 1986, it’s possible to make a tax-free distribution from the company to the shareholder up to the amount of the shares’ tax cost. Fortunately the crystallization process provides the opportunity for creating the necessary tax cost on the shares.
5. **Repeal of legislation** – The capital gains exemption legislation could be repealed at anytime and without any warning.

Business owners do not have to wait until the day they sell their company to take advantage of the capital gains exemption. Numerous benefits can be realized from crystallizing the exemption in advance of the eventual sale.



## The Fall is a Great Time for Tax Planning

Tax planning is typically viewed as a once a year event. As December 31 approaches, many people scramble to come up with tax planning options, which can lead to missed opportunities. So as summer draws to a close and we get back to business in September, it is an opportune time to give careful consideration to your year-end tax planning. Here are a few suggestions to consider:



### Capital Dividends from Your Corporation

When a corporation realizes a capital gain, one-half of the gain is subject to taxation. The other half creates a notional account called a capital dividend account (CDA). This CDA can be paid by the corporation to its shareholders as a tax-free dividend. The capital dividend account is an accumulation of the tax-free portion of capital gains less the non-deductible portion of capital losses realized by a corporation, plus proceeds received on corporate owned life insurance policies upon the insured's death, plus the nontaxable portion of dispositions of eligible capital amounts, plus the amount of capital dividends received from other corporations.

The CDA is calculated from the date of incorporation, or as far back as December 31, 1971, to the point in time when a capital dividend is declared (subject to adjustments for eligible capital property).

Investors will often sell securities near year-end to realize capital losses on securities to offset gains

realized during the year. If the capital losses are realized prior to the payment of a capital dividend, one-half of the capital loss will erode the corporation's CDA. Therefore, if your corporation has incurred capital gains during the year and has CDA balance to be paid out, it is prudent to pay a capital dividend prior to realizing capital losses at year end.

A careful calculation of the CDA balance should be undertaken prior to any capital dividend payment. Additionally, it's important that the proper tax election forms are completed and filed with the Canada Revenue Agency before paying the dividend.

### Review Corporate and Personal Tax Installment Balances

A corporation required to pay 2011 monthly tax installments typically calculates the amount of installments based on the taxes calculated on the 2010 corporate tax return. However, the corporation will only be required to remit the lesser of the actual 2010 corporate taxes payable, or the estimated 2011 corporate taxes payable. Therefore, if the estimated 2011 total corporate taxes are likely to be less than 2010, you may choose to reduce your required installments for the year. It may be difficult to predict the 2011 total corporate taxes now, but if your year-to-date taxable income is less than 2010's year-to-date taxable income at the same point in the year, it may be worthwhile to perform a full calculation and reduce the remaining 2011 corporate tax installments accordingly. Reduced installment payments could provide a cash flow benefit to the corporation.

The same benefit of reduced personal tax installments is available for individuals experiencing a reduction in their personal income for 2011.

These are just a couple early fall tax planning ideas. For more ideas contact your local DFK representative.



## The Importance of Having a Will

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We are often reminded of the importance of having a will to ensure our wishes are carried out when we pass away. If a person doesn't have a will, the distribution of their estate is determined by provincial law. Dealing with someone's estate becomes more difficult, especially if the person had minor children at the time of their passing.

There are other less known, but important, reasons for having a will. For example, adding someone's name to a bank account or other financial account is not sufficient to ensure those accounts are passed on to that person.

A 2007 Supreme Court of Canada ruling confirmed that the assets in joint accounts are the property of the person who contributed them unless there is sufficient evidence to prove that a gift to the

other account holder was intended. If the intention to make a gift cannot be proven, then the account becomes part of the estate. Without a will, the account could go to someone other than the person you intended.

Common law couples should ensure their will properly addresses their common law partner. The rules governing estates differ from province to province. In some provinces, estates legislation does not recognize common-law couples. In those provinces, the deceased's estate would be distributed as if they had no partner. Therefore it is of paramount importance your will is in accordance with provincial laws.

For more information, speak to an advisor at your local DFK affiliate.

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