

Minding YOUR BUSINESS



S U M M E R 2 0 1 0

From The Desk Of

Changes at Majewski Shaler & Co.

After fourteen years working at Majewski Shaler & Co., Sandy Rodrigues has tendered her resignation in favour of a career change working in industry. Sandy has been a significant asset to our firm managing both internal office affairs and looking after clients' needs and requirements diligently. Sandy's professionalism and competence has been appreciated by the many clients she has come into contact with over the years. Sandy will be greatly missed. We wish her much success in her new career choice.

Karen Schenkeveld, C.G.A. has recently joined our firm and will be filling Sandy's shoes. Karen will work closely with Dan familiarizing herself with client files and affairs. We look forward to introducing her to our clients over the coming months. Karen has had twenty years of public practice experience working with private company clients and high net worth individuals as a manager with several mid-size public accounting firms. We welcome Karen to our team and assure you that your affairs are in good hands. As always, Dan and Barrie remain at the helm and will continue to assure the delivery of the highest degree of service that our clients are accustomed to.

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After the Estate Freeze

An estate freeze is a common strategy for putting a cap on the older generation's tax liability on transfer of their corporate interests to younger family members. The value inherent in the company is converted into fixed value preferred shares, and the next generation(s), directly or indirectly, acquire the future income and growth in the form of common shares.

"Planning for this future tax cost."

But accumulated value remains owned by the older generation, and will attract tax when they pass away. In some cases, the preferred shares are redeemed over time to provide the older generation with cash for their living expenses. But in many cases, the older generation has other sources of income, and don't need to draw on their corporate equity – and, in fact, does not wish to, because they want to leave the cash flow in the company and/or do not want to pay the personal taxes which would arise on deemed dividends from the company.



Where the older generation holds investments, there may be planning opportunities to eliminate those preferred shares without attracting an extra tax cost to the older generation.

Consider a simple example. Sylvia is a widow. She has frozen her interest in the family business, FamCo, into fixed value preferred shares redeemable for \$5 million. Sylvia's personal cash requirements are provided for through RRSP's and an unregistered investment portfolio, the latter having a value of \$10 million and generating annual investment income of \$300,000. Sylvia is very conservative, and her portfolio consists of long-term Guaranteed Income Certificates and similar

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" If nothing ever changed, there'd be no butterflies. "
Author Unknown

OUR COMMITMENT *To You.*

We recognize that while "accounting" is an integral part of your business, it is only a part of your business. Our approach to accounting doesn't miss the forest for the trees or the people for the numbers. Our dedicated professionals will provide you with the creative, proactive and timely solutions to assist you in responding to the daily challenges confronting your business.



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After the Estate Freeze

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investments, generating interest income. As matters stand, Sylvia will pay tax on capital gains of \$5 million on the Famco shares on her death. The only way to reduce that tax exposure is to pay tax on these shares during her lifetime.

"Whether this simple restructuring might create significant tax benefits."

Or is it? What if Sylvia transferred her interest-bearing investments to Famco, taking back a loan bearing no interest? The portfolio would generate \$300,000 of interest income each year, attracting corporate taxes and refundable dividend tax. The corporate tax rate in B.C. on investment income is 45.17%, of which 26 2/3% is refundable dividend tax.

"Integration of investment income"

Famco pays \$135,500 of taxes, of which \$80,000 can be recovered by paying dividends of \$240,000. After the dividend refund, Famco has \$244,500 of after tax cash

(\$300,000 of interest, less \$55,500 of taxes net of dividend refund), and can use this to redeem a portion of Sylvia's preferred shares. Sylvia will pay personal taxes on the resulting dividends, of course. However, had she done nothing, she would have paid tax on the annual interest income. In B.C., the combination of corporate tax on investment income plus personal tax on dividends of the after-tax earnings is \$5,000 higher than the cost of personal tax if the investment earnings were taxed personally, so Sylvia's after tax cash retained will not change significantly.

"The annual reduction in these deferred taxes."

It would take almost 21 years to eliminate Sylvia's Famco preferred shares in this manner (at which time she can call her loan and take back her GIC's). However, if she does nothing, her preferred shares will be unchanged. This approach will reduce her capital gains on death by \$240,000 for every year this strategy is applied.

Value of Voting Non-Participating Shares

In an October 9, 2009 Technical Interpretation, CRA was asked to give their opinion on an Estate Freeze situation where Mr. A froze his common shares by converting them into Class B shares which were non-participating, non-voting, redeemable at the option of the holder at a redemption price equal to the consideration received by the corporation at the time of their issuance, and entitled to an annual dividend of a maximum of 6%.

In addition, Mr. A was going to retain control of the company through the issuance to him of either Class C shares (non-participating, voting, redeemable at the option of the holder at a redemption price equal to the consideration

received by the corporation at the time of their issuance and entitled to an annual dividend of a maximum of 6%), or Class D shares (non-participating, voting, and redeemable by the corporation at a price equal to the paid-up capital for such shares) or Class E shares (non-participating, voting and automatically redeemable by the corporation on the shareholder's death for a price equal to the paid-up capital of such shares).

CRA noted that if the Freezor was retaining control of the corporation to protect the economic value of his interest in the corporation and he died a few years after the freeze, in general, the CRA would not attribute a premium to the Classes C, D or E.

Tax Tips & Traps

TAX-FREE SAVINGS ACCOUNTS (TFSAs)

TFSAs have been available since January 1, 2009. Generally, an individual's TFSA will lose its tax-exempt status upon death. However, if a spouse or common-law partner is the "successor account holder," the account will maintain its tax-exempt status.

Even though TFSAs provide for the designation of a spouse or common-law partner as the "successor account holder," many institutions did not provide this on the initial application forms. Today, every person can name the spouse or common-law partner as the "successor account holder" for their TFSA to obtain the rollover treatment on death. Therefore, persons that acquired TFSAs earlier in 2009 should consider going back to the financial institution and complete the required forms.

In an October 10, 2009 National Post article by Jonathan Chevreau a number of TFSA issues were discussed including in June 2009, Ontario announced legislation simplifying the beneficiary designation. Even though TFSAs are regulated federally, they are subject to provincial legislation concerning the transfer of assets after death. Generally, the fair market value of the TFSA can be received by the estate on a tax-free basis. A disadvantage is that this would be subject to probate fees. Where the spouse or common-law partner is concerned, it may be better to name him/her as a "successor account holder" which is different from a beneficiary. Therefore, the spouse steps into the shoes of the TFSA owner. Also, the recipient's TFSA contribution room is unaffected.



Ontario will now permit a person named as a beneficiary (including children or other individuals) to receive the assets in a TFSA without them going through the estate and incurring probate costs. A spouse could be named as a beneficiary but it is usually better to name them as a "successor account holder."

Also, commencing in 2010, TFSA issuers will have to electronically file a TFSA return with CRA by the last day of February following the calendar year to which the information applies.

TRANSFER OF CAPITAL LOSSES BETWEEN SPOUSES

In 2003, CRA confirmed that capital losses could be transferred between spouses when there is a transfer of property at fair market value. This results in a denial of the capital loss for the spouse who disposed of the property and an automatic addition to the Adjusted Cost Base of the property for the spouse who acquired the identical property.

In a September 10, 2009 Technical Interpretation, CRA confirmed that it still accepts the transfer of latent capital losses between spouses regardless of the recent

decision in the Lipson case which noted that the use of attribution rules to favour a taxpayer may trigger the Anti-Avoidance Rules.

BENEFICIAL OWNER OF A RESIDENCE

In a March 30, 2010 External Technical Interpretation, CRA reviewed a situation where Sister A wished to acquire a house but she did not qualify for a mortgage. Therefore, Sister B acquired the house, as she qualified for a mortgage, but Sister A is the beneficial owner of the house, lived in the house, and covered all house-related expenses, such as mortgage payments, municipal property taxes, utilities, insurance, repairs and maintenance.

Sister A now qualifies for a mortgage so Sister B wants to transfer the legal ownership to Sister A and wants to confirm with CRA that there is no disposition.

Good News!

CRA notes that a disposition does not occur for tax purposes if there is a transfer of title that is not accompanied by the transfer of beneficial ownership. CRA notes that the primary attributes of beneficial ownership include possession, use and risk.

In the present case, CRA notes that it appears that Sister A is the beneficial owner of the house and, therefore, there would be no disposition when title is transferred from Sister B to Sister A.

PERSONAL SERVICE BUSINESS

In a March 19, 2010 Tax Court of Canada case (609309 Alberta Ltd. (609309) et al vs. H.M.Q., the Court found that 609309 was carrying on a Personal Services Business in 1998 and 1999.

Therefore, its expenses were restricted and its small business deduction disallowed.

Mr. Nance was employed by Spantec Construction Ltd. (Spantec) in 1993 and 1994 as an ironworker. In 1997, he and his wife formed 609309 through which he provided construction management services to Spantec. His wife did the internal administration for 609309.

The Court noted that relevant criteria include:

- (i) the intent of the parties;
- (ii) control over the work;
- (iii) ownership of tools;
- (iv) chance of profit/risk of loss; and
- (v) the business integration, association or entrepreneur criteria.

In this case, there was little evidence with respect to the "intent" between the parties.

With respect to control, the Court found that the control that Spantec had and needed over the services provided by Mr. Nance were such that a proper characterization of his services, had he contracted directly with Spantec, would have been one of employment.

With respect to the ownership of tools, 609309 provided the laptop used by Mr. Nance, however, Spantec provided the pickup truck and workspace. No other tools were needed. This consideration did not lead the Court in one direction over the other.

With respect to the opportunity for profit or loss, 609309 was limited to \$44 per hour worked by Mr. Nance plus the additional \$75 daily living-out allowance. All related expenses, including insurance, were borne by Spantec except for Workers Compensation. The only risk of loss to Mr. Nance and 609309 was getting caught in a potential insolvency of Spantec.

The Court concluded that overall it is hard to see how a worker on these contracted financial terms with Spantec could be said to be in business for himself.

DEATH—CORPORATE OWNED INSURANCE

In a January 19, 2009 Ontario Superior Court of Justice case (Ribeiro Estate vs. Braun Nursery Limited (BNL)), BNL acquired insurance policies on the lives of the shareholders. The Agreement specified that any insurance proceeds received by BNL were to be used to repurchase the BNL shares from the deceased shareholder's Estate.

On the death of Mr. Ribeiro, BNL received \$1 million of life insurance and a credit to its capital dividend account (CDA). When the corporation used the funds to repurchase the shares from the Ribeiro Estate the corporation did not elect to have the deemed dividend out of the CDA.

Ribeiro Estates Loses

The obligation of BNL to use the insurance proceeds to purchase the deceased's shares protected the deceased shareholder's Estate but, not beyond. There was no further requirement on BNL to use the increase in the CDA attributable to the insurance policy to reduce the tax consequences on the deemed dividend to the Ribeiro's Estate. A tax-free vs. taxable dividend would have saved the Estate \$250,000.

Editor's Comment

Shareholders should document the purpose of corporate-owned insurance and indicate who is entitled to the CDA that is created through the receipt of the insurance proceeds.

If this is not provided for, surviving shareholders may claim the CDA for themselves.

We also wish to announce the addition of Leona Lei to our team serving in the capacity of staff accountant. Leona will be mentored by Karen and work under Karen's direction. Leona has completed all the academic requirements for the C.G.A. designation and is now fulfilling her practical experience requirements. Many of our clients will have the opportunity to meet Leona as well. Please join us in welcoming Leona to Majewski Shaler & Co. should the opportunity present itself.

Well, as Maggie Muggins once said, it has been quite a day. As we all have heard, change is the one constant we can count on. On that note, we look forward with positive anticipation to continuing to build on our strengths and to living up to our commitment to our clients; "to provide creative, proactive and timely solutions to assist you in responding to the daily challenges confronting your business." Please be in touch with us should you have any questions or concerns that arise. Enjoy a wonderful summer.

Dariusz Jędrzejewski

Bonnie Shaler

