

YEAR END TAX PLANNING FOR PRIVATE COMPANIES

The following article is intended to provide a checklist of year-end and general GST and income tax planning tips for both individuals and corporations. The planning ideas are presented in point form and readers are cautioned to check with their advisor before implementing any of the ideas.

SMALL BUSINESS

- If addition made to building in Class 3, and the cost does not exceed the lesser of \$500,000 and 25% of total cost of building, the addition qualifies for Class 3 (i.e., 5% CCA). Consider alteration of pre-1988 building instead of acquiring new building which would be in Class 1, eligible for 4% CCA.
- If land sold with no allocation to building beware terminal loss reduced by amount of capital gain on land.
- Vendor may wish to elect under Regulation 1103(1) to include depreciable properties in Classes 2 to 12 in Class 1 prior to sale to avoid recapture.
- Available-for-use rule applies for property acquired after 1989. This delays time for CCA, investment tax credits and certain R&D expenses. Building available-for-use at time when all or substantially all the building used for its intended purpose (90% of test), the construction, renovation or alternation is complete or in any event after two years. If the two-year rolling start rule applies, the half-year rule does not apply.
- Properties (other than buildings) are available-for-use at earliest of the time when they are first used for purpose of earning income or after two years.
- Cannot accelerate available-for-use time by leasing to non-arm's length person.
- Investment tax credits claimed affect capital cost allowance claims by choosing appropriate year-end.
- Where possible, sell assets after year-end in order to defer any recapture or capital gains for depreciable property and to permit one last claim for CCA.
- If property stolen, destroyed or expropriated or a former business property is voluntarily disposed, it may be possible to defer the tax on gains by acquiring a replacement property. A former business property is real estate (other than a rental property) used more than 50% for the purpose of gaining or producing income from business. Technical Amendments* have expanded to included real property leased to a related corporation carrying on a business for dispositions after July 13, 1990. A further Technical Amendment also purposes to restrict the benefit of replacement property located in Canada. The property must also be acquired for the same or similar business. For an involuntary disposition, the property must be acquired two years after the date of loss or destruction.



- Corporate partnerships should be considered as they offer separate year flexibility with respect to cash management. They may also facilitate the admission and withdrawal of partners. However, if corporate partnerships are used to acquire real estate, consider whether all partnerships are principal business corporations for the purpose of the rental property restriction and for the transitional rules for construction period soft costs. Corporate partners do not benefit from the \$1 million de minimis rule for vacant land. This rule would allow a real estate company to deduct interest and property taxes in excess of revenue from the property to the extent of \$1 million times the prescribed rate of interest. Corporate partners share the benefit of income eligible for the small business deduction in the same manner as profits are shared.
- A maximum reserve of three years is available to defer tax for amounts receivable in future years (e.g., land inventory).
- A reserve is available for capital gains but must report a minimum amount equal to one-fifth of the gain in each year.

LOSSES

- Three-year carry back and indefinite carry-forward of net capital losses.
If control is acquired, lose net capital losses for taxation years ending prior to acquisition of control. If no previous taxable capital gains, consider election under 111(4)(e) if own appreciated capital property. Property deemed disposed of at designated amount between ACB and FMV and reacquired at same amount. Elect amount equal to ACB plus capital loss. The election is available for all capital properties (recapture if depreciable property). May also be able to rollover property with accrued gains to Losses Company before change of control and either have Loss Company sell asset to third party or make the election.
(For non-capital (business losses), three-year carry back and seven-year carry-forward)

On an acquisition of control, non-capital losses for prior taxation years can be carried forward only if loss business carried on throughout the year in which loss applies, business carried on with reasonable expectation of profit and loss carry forward deductible only to the extent of losses from the same or similar businesses.

For Canadian-controlled private corporations, consider carrying forward the non-capital loss if prior years' income of corporation reduced to \$200,000 (i.e., deduct loss against future income in excess of \$200,000 taxed at higher rate).

Divert income to loss corporation, e.g., loan funds to loss corporation or rollover profitable business to loss corporations (assume no real creditors).

Can amalgamate (use losses against income of amalgamated corporation) or wind-up loss company (use losses against income of parent for your following tax year in which wind-up commenced unless capital gain unlikely).

- Better to apply capital losses, consider against future rather than past ten years to avoid grind-down (i.e., as only one-half or two-thirds of capital loss was deductible in the past year) unless capital gain unlikely.
- If you incur capital losses, consider the creation of capital gain by acquiring flow-through share or film investment as may result in income deduction and capital gain.



- Carry back of net capital losses may reduce RDTOH and may create a problem if a dividend refund was claimed by the corporation on previous payment of taxable dividends.
- Carry back non-capital losses because no grind and tax rates may have been higher in the past with the result that a greater refund is available
- Apply non-capital losses otherwise expiring against taxable capital gains.
- Minimize current losses by not claiming doubtful accounts, or deposits because these only provide for a year deferral. Claim capital cost allowance on classes with low rates and consider whether to forego claim of capital cost allowance on other classes.
- Sell appreciated assets to utilize and to generate gain to offset capital losses.
- Consider refinancing corporate debt by having another corporation in the group borrow money and invest in Loss Company. Loss Company may reduce bank loan and thus interest expense. This may result in Loss Company being profitable.
- Deemed year-end where control of corporation acquired. If one of the main reasons for acquisition of control is to trigger a loss, the deduction of the loss may be denied. However, the change of control may be advantageous if the loss is in initial part of year, with gains anticipated for balance of year.
- On acquisition of control, if FMV of class of depreciable property less than undepreciated capital cost of UCC (i.e., accrued terminal loss), excess deemed allowed as CCA for taxation year ended prior to year of change of control and treated as a non-capital loss. Deemed loss cannot be carried back. If UCC of class greater than FMV of class before change of control, excess deemed CCA in year increases non-capital loss. Consider election under 1103(1) to include property in Classes 2 to 12 in Class 1 to avoid or minimize write-down. Alternative may be to rollover depreciable property to related company before changing control.
- If capital gain realized by corporation in the year, goodwill sold or proceeds from life insurance received, consider payment of maximum capital dividend. Otherwise, future capital losses may reduce capital dividend account.
- If tenant acquired leasehold interest in the year, capital cost of leasehold interest added to cost of property acquired. CCA previously claimed with respect to leasehold deemed to be CCA previously claimed with respect to acquired property.
- If tenant acquires property pursuant to an option in lease and then disposes of the property, there may be recapture of rent paid. Cost to tenant equals the exercise price and rent paid up to the fair market value of the property at that time. The difference between the exercise price and the deemed cost is deemed to be previously claimed as CCA.
- Specified leasing property rules may apply where lease term is greater than one year, FMV or lease property is greater than \$25,000 and lease property is not prescribed property (office furniture and equipment and EDP equipment having cost not greater than \$1 million, residential furnaces and heaters and consumer electronics, automobiles and light trucks and buildings). If specified lease limit on CCA claimed by lesser it is equal to lesser of amounts that would be repayments of principal on deemed loan and CCA otherwise claimed.



FINANCIAL DIFFICULTY

- Deduct bad debt as capital loss when corporation insolvent.
- Deduct share investment as capital loss if corporation bankrupt or winding up order or corporation that ceased to carry on business was insolvent at end of year, FMV of shares nil and company to be dissolved or would up and not carry on business.
- Deduction for share or debt may be business investment loss if small business corporation.
- On a mortgage foreclosure, conditional sale, default sale or any other situation where a creditor acquires property, a debtor is deemed to dispose of the property for the principal amount of the debt owing (which may include debts assumed by the creditor). Accrued interest is excluded but may be taxable if deducted. The creditor acquires the property at a cost equal to the principal amount of his debt (i.e., may be discounted from face value) minus any reserves deducted in the preceding year (reserves not included in creditor's income for year of acquisition plus any assumed debts).
- If debt forgiven, losses are reduced for preceding years (not for current year) as follows:
 - Non-capital losses, farm losses, not capital losses and restricted farm losses. The balance reduces the capital cost of depreciable property or the ACB (tax cost) of capital property (not eligible capital property). The principal amount of debt includes interest payable that was deducted or deductible.
 - Section 80 may apply if debt is inverted to preference shares where the preference shares have a value less than debt.
 - If a company borrows and repays the shareholder who reinvests in shares so that the company repays the bank, section 80 may apply unless the cost base of the shares is limited to the net increase in fair market value of the shares.
 - It may be possible to avoid section 80 by making a cash gift to a related party who has previously borrowed money in order to repay the loan from the donor.
 - A business may claim a reserve for doubtful accounts. The reasonable reserve depends upon the period of arrears or default, the financial statements and prospects of the debtor, the debtor's past record and the value of security taken. The amount of the reserve depends on the creditor's history of bad debts, industry experience, economic conditions and the cost of collection.

OWNER / MANAGER REMUNERATION

SALARY/DIVIDEND MIX

- Pay bonus to owner/manager of corporation of active business income in excess of \$300,000 to maximize claim for small business deduction.
- If the corporation's active business income is \$300,000 or less, consider taking sufficient salary to make RRSP contribution and take advantage of personal tax credits. Balance may be paid as a dividend.



- To be deductible, a bonus must be paid within 180 days after fiscal year end.
- A corporation should have a year-end in the last six months of the calendar year in order for the corporation to be able to deduct the bonus on an accrual basis and to maximize the deferral.
- It may be possible, if the employer is willing defer the deduction on the bonus to defer the payment of the bonus to the employee for up to three years. The employee would only be taxable on receipt.
- If an individual has a cumulative investment loss problem, it would be possible to create interest income where that individual has loans outstanding to his corporation. This may be accomplished by having the corporation pay interest. If the corporation's income is in excess of \$300,000, interest is preferable to the bonus (as the 180-day rule does not apply). The loan may also be secured.
- Consider retaining the profits in the company where the corporation profits are eligible for the small business deduction, the shareholders do not require funds or the corporation has loss carry forwards.
- Take dividends when the company has:
 - (i) Refundable dividend tax on hand,
 - (ii) Balance in its capital dividend account, or
 - (iii) Income, which has been subject to the small business deduction.
- Avoid carrying non-capital or net capital losses back to a year in which the corporation had refundable dividend tax on hand and a dividend refund was received. This may result in a reduction or elimination of the dividend refund and an additional tax.

SHAREHOLDER BENEFITS

- Beware of having the corporation acquire personal use assets to be used by the shareholders, as the taxable benefit may be based not on the equivalent rent of such assets, but rather on the lost opportunity cost to the corporation. The benefit will be fair market value of the property times the prescribed rate.
- A shareholder is subject to imputed interest on advances until the advances are repaid. Consider declaring dividends payable early in the year and permitting the shareholder to draw against the dividends payable rather than treating the amount as advances. This may avoid imputed interest.
- Shareholder loans must be repaid within one year from the end of the company's taxation year unless:
 - (i) The loan was in the ordinary course of the lender's business;
 - (ii) It was a home purchase loan to employee;
 - (iii) It was a share purchase loan to employee for treasury shares; or
 - (iv) It was a car purchase loan to the employee
 - (v) And, in each of these cases, bona fide arrangements must be made for repayment.



COMPANY CARS

- If a car cost less than \$24,000 new, an employer is neutral as to whether or not to provide the employee with a company-owner vehicle or paying additional salaries to the employee to assist the employee in purchasing a car.
- A company-owner car is generally not attractive if it has a cost in excess of \$24,000; the company is denied a deduction for the excess capital cost allowance or lease payments and the employee is taxable on the standby charge based on the purchase price of the car.
- If an employee has the use of a company-leased vehicle and has only nominal business use. Consider a long-term lease with a substantial prepayment in the first year of the lease. The employee's taxable benefit is computed with reference to two-thirds of the lease payments. One-third of the lease payments are a tax-free benefit.
- If extensive business use of an automobile (but less than 90 per cent), exclusive should personally purchase the car and consider direct payment of the expenses by the employer rather than an allowance. The employer may deduct a reimbursement (avoid 31/25 cent kilometer limitation) and no taxable benefit to employee.
- If more than 90 per cent business use and low personal mileage, company-owned or leased vehicle may be attractive because of reduction in standby charge.

INTEREST DEDUCTIBILITY

- A corporation may be denied the related interest expense if it borrows money to lend on a non-interest basis or pays dividends in excess of accumulated profits.
- If a corporation borrows money to make an interest-free loan to an employee, then the related interest expense should be deductible.
- If an individual has borrowed money and re-loans funds to the corporation or has given a guarantee for inadequate consideration, then the shareholder would be entitled to deduct the related interest expense only if the corporation used the loan to produce income from a business or property and the corporation could not obtain financing at the shareholder's interest rate without the shareholder's guarantee. A deduction of interest on money borrowed must not result in an artificial or undue reduction in income.
- It is clear that interest will be deductible only where it may be traced to an investment, which yields income from a business or property. Ensure that there is a paper trail for all loans. It may be possible to borrow for an indirect use only if income from a business.



YEAR END TAX PLANNING FOR INDIVIDUALS & NON-INCORPORATED BUSINESS

- An Individual would want to maximize deductions or credits claimed in the year that the payment is made.
- Safety deposit box fees
- RRSP administration fees
- Legal and accounting fees
- Investment counsel fees
- Moving expenses
- Professional fees
- Interest expense
- Tuition fees
- Childcare expenses.
- An aggressive filing position would be for self-employed individual to claim the expenses of a nanny as a business expense. The taxpayer was successful in such an argument in *Symes vs. The Queen*, 89, which has been appealed.
- An individual may consider accelerating or deferring:
 - Charitable donations
 - Political contributions
 - Elective medical expenses.
 - Where an individual's income exceeds \$50,000, old age security and family allowance benefits are taxable. The special tax is equal to the lesser of:
 - (a) Old age security plus family allowance benefits: and
 - (b) 15% of income in excess of \$50,000.
- Interest on investment contracts and prescribed debt obligations acquired after 1989 are to be included annually in an individual's income. An investment contract includes any debt obligation (e.g., compound debt obligations including Canada Savings Bonds). It also includes zero coupon, strip coupons and strip bonds.

Investment exempt from the annual accrual rule are:

- Investment in shares
 - Prescribed annuities
 - Exempt life insurance policies
 - Investments in RRSPs, RPPs, DPSPs and other similar tax deferral plans.
- If an individual assists a family member in starting a business by way of an interest-free loan or a loan guarantee without consideration, then any resulting loss would not be deductible. In order to ensure that a capital loss or business investment loss arise, a reasonable guarantee fee should be paid for a loan guarantee and an interest-free loan should be converted into preferred shares of a corporation.
 - The family unit may designate only one principal residence per year. There are special rules where each spouse owned a separate residence prior to 1982. Where a second residence is currently owned, maximize use of capital gains exemption available where the ownership is joint.



- If you convert a principal residence to rental property, there is a deemed disposition at fair market value unless you elect to be deemed not to have a change in use and therefore no deemed reacquisition if you reuse property as a residence. You would have to file the election with the return for the year in which the change of use occurs. There is a four-year limitation on relocation of place of employment.
- On the sale of any art, jewellery, rare books, manuscripts and folios, stamps and coins, there is no gain or loss where the sale price is under \$1000.
- For capital losses, consider deferring capital losses until capital gains exemption is used. Use capital gains exemption first before utilizing capital losses.
- It may be possible to shift a loss from one spouse to the other subject to the general anti-avoidance rule. If one spouse wishes to sell an investment, which has decreased in value but cannot use the loss, the other spouse may acquire the same or a similar investment prior to or within 30 days of the sale to an arm's length party. The net effect would be to deny the loss to the spouse who initially sells the shares and to add the loss to the shares acquired by the other spouse who may then dispose of the shares and claim the loss.
- If commodities are owned and have decreased in value, consider sale of commodities to children, parents or brothers and sisters for a promissory note and if first disposition of commodities, claim a non-capital loss deductible against other sources of income.
- To crystallize a capital loss, sell investment on market or to children, brothers or sisters, or parents prior to year-end.
- Crystallize capital gains exemption by transferring investment to holding company for shares only, to spouse, children, parents or brothers and sisters.
- In order to crystallize the \$500,000 exemption for shares of a small business corporation, consider transferring shares to a holding company in consideration for common shares. The shares may be transferred at fair market value or if the value exceeds the unused capital gains exemption, an election may be filed under section 85 to deem the asset to be transferred for its cost plus the unused capital gains exemption. The paid-up capital of the shares received would be restricted to avoid a deemed dividend to the greater of the ABC and the paid-up capital of the transferred shares.
- An alternative method of crystallizing the capital gains exemption would be to reorganize the share capital of the operating company so as to convert the existing common shares to a new class of shares. An election would be made under section 85 of the Income Tax Act to elect that the transfer occur for an amount equal to the cost plus the unutilized capital gains exemption. The effect would be to increase the cost base of the shares of the small business corporation. No deemed dividend would arise. If a corporation is not a small business corporation because at least 90% of its assets are not employed as an active business carried on primarily in Canada, consider taking steps to purify the corporation. This would involve taking advantage of corporate rollovers in order to remove non-qualifying assets, possibly by transferring them on a tax-deferred basis to a sister corporation. A capital gain rather than a tax-free inter-corporate dividend may arise on the corporate spinoff where inter-corporate shareholdings are redeemed if the reorganization occurred in contemplation of a share sale. It may be prudent to review the corporation's balance sheet and to effect such a reorganization at year-end (and before the shares are offered for sale or an offer is received).



- Consider incorporating a sole proprietorship pursuant to section 85 prior to sale and then selling the shares in order to take advantage of the \$500,000 capital gains exemption.
- Beware of the attribution rules where property has been transferred or loans made to a spouse or to a minor child or to a corporation (other than a small business corporation) where the purpose was to benefit a spouse or minor child. In the case of a transfer to a spouse, the transferor will be taxable on all income and capital gains realized on the property transferred. For minor children, there is attribution of income (until the child reaches the age 18) but not of capital gains. On the transfer or loan to a non-small business corporation, there is imputed interest on the value of the property transferred where a spouse or minor child is a shareholder and one of the main purposes of the transaction was to reduce tax.
- A non-arm's length loan at less than a commercial rate of interest to an individual (minor children and parents) will subject the lender to tax on any property income (not business income) earned where the reason for the loan was to reduce or avoid tax. This provision would not preclude gifts to adult children or parents or loans to a family member who wants to invest in an unincorporated business where that person will be active or to loan funds to a corporation owned by adult children (whether or not it qualifies as a small business corporation). Loans may be made to minor or adult children or to parents to enable them to acquire assets giving rise to capital gains.
- There is no income attribution on loan or gifts from non-residents.
- The attribution rules only apply to income earned on the original loan and would not apply to any income earned by the borrower on the reinvestment of the income in a subsequent year. Income on income is not subject to attribution.
- If funds are loaned to assist a family member in acquiring a limited partnership interest or a partnership interest where that partner is not active, the attribution rules apply.
- A planning technique for next year is to have the lower income spouse save his or her salary and to have all household expenses borne by the higher income spouse. This would obviate the necessity for a transfer of funds in order to create a pool of capital for the purpose of generating investment income taxable to the lower income spouse.
- Consider contributing to a spousal RRSP where a spouse cannot otherwise contribute to and RRSP and the objective is to split retirement benefits.
- It is possible to split Canada Pension Plan benefits where both spouses are at least age 60 and have applied for the benefits. On assignment, each spouse receives a portion of the other spouse's retirement pension.
- A non-deductible contribution may be made to a registered education savings plan for a beneficiary. The funds accumulate tax-free. If a child does not attend a designated institution, the capital contributions (not accumulated income) are returned. In that situation, it may be possible to designate another child.

If a child does attend a designated institution, the child is taxable on the RRSP payment representing accumulated income. The maximum contribution limit per beneficiary is the lesser of \$1,500 per year (for a maximum of 21 years) and the amount by which \$31,500 exceeds the total contribution of preceding years. It is not possible to make multiple contributions for the same beneficiary.



DEFERRED COMPENSATION

(1) RRP - Employer Contribution

- Current service \$3,500
- Additional current service or past service requires actuarial determination.
- Required contribution for past service credits under defined benefit provision on the plan
- Additional voluntary contribution for current service provided required contribution plus additional voluntary contribution does not exceed \$3,500.
- No additional voluntary contribution for past service contributions made after October 9, 1986

(2) DPSP

- Employer deducts maximum of \$3,500 from employee.
- 1990 is the last year that an employee may make a maximum non-deductible contribution of \$5,500 (return tax-free)

(3) RRSP Only

- 20 % of earned income to maximum \$7,500.
- Contribution within 60 days after end of year (or death to spousal RRSP only).

(4) RRSP and RPP/DPSP

- 20 % of earned income to maximum \$3,500 minus deductible employee contributions RPP.
- In addition can transfer \$6,000 of periodic registered pension plan or deferred profit sharing plan income to spousal RRSP (does not affect contributions to spousal RRSP, does not include old age security, Canada Pension Plan, Quebec Pension Plan).

TAX SHELTERS

(c) FILM DEALS

Private film deals are available whereby an investor would benefit from a 30% rate of capital cost allowance may only be claimed against the film revenue. Most film deals will have presales of 60 to 75 % of the investment. Ontario and Quebec film deals also have provincial incentives. The film deal may be structured as a limited partnership with the investor having a put of the partnership interest at fair market value prior to the earning to the presale. The GAAR Committee of Rulings Division has recently challenged this arrangement. As a result future deals may not have a put and current deals should have an advance income tax ruling. These investments are of interest to persons who have not used their capital gains exemption, have significant capital losses or wish to obtain a deferral in tax.

(d) RESOURCE DEALS

There are some grandfathered flow-through share deals which offer investors a 100% write-off for exploration and a 30 % tax free grant under the Canada Exploration Incentive Programme which was closed in February 1990. Quebec deals have additional incentives for Quebec residents.

Investors would have a nil tax cost and capital gain on the sale of the shares. These investments would be attractive to investors who have an unutilized capital gains exemption or capital losses or confidence in the resource company.

(3) COMMISSION WRITE-OFFS

There have been several syndications whereby a limited partnership is formed to arrange for the distribution of mutual funds. The partnership pays registered dealers sales commissions. The partnership receives a monthly fee based on a percentage of the net asset value of the fund plus redemption charges. Advance tax ruling were obtained that payment of selling commissions were deductible when incurred by the partnership and that the general anti-avoidance rule was not deductible. The investors could deduct their interest expense and their share of losses up to the at-risk amount.



(4) FARMING DEALS

These investments are designed to enable investors to take advantage of the maximum write-off of \$8,750 per year computed as \$2,500 plus the less of \$6,250 and one-half of the net loss in excess of \$2,500. The maximum deduction is available if there is a \$15,000 loss. There is a broad definition of farming which would include horses and livestock and fish farms.

(5) MOTOR HOMES AND YACHTS

There have been some syndications but these do not offer significant tax shelter benefits as they are subject to the leasing property restrictions. Capital cost allowance may not be claimed in excess of net rental income. Investors may deduct interest and other operating losses.

(6) REAL ESTATE SYNDICATIONS

- There have been many real estate syndications offered for investors who are interested in some tax incentives and the hope of capital appreciation. These are not tax-motivated deals. Syndications may be in apartment buildings, office buildings, townhouses, condominiums, warehouses, shopping centers, retirement homes, nursing homes, restaurants and land held for development. The properties may be in Canada or the U.S.
- These investments are structured either as limited partnerships, co tenancies or direct ownership.
- A limited partnership offers the ability for the investors to deduct interest on borrowed money used to acquire less than 10% interest in the partnership thus avoiding the restriction on the capitalization of interest on vacant land, the restriction on the deductibility of construction period interest and allowing the partnership to maximize its claim for capital cost allowance notwithstanding the rental property restriction.
- The syndications may take advantage of pre-construction and post-construction soft costs, which are deductible over the period benefited, over five years or on a current basis depending on the particular expense.
- For U.S. syndications, some deals are structured as direct investments by Canadian investors with the result that the Canadian investors must file annual U.S. personal tax returns and be exposed to U.S. estate tax on death. The other structure would involve a two tiered partnership with a Canadian limited partnership being the sole limited partner in the U.S. partnership. Apparently, the U.S. accepts that the Canadian limited partnership may be structured so as to be an association for U.S. purposes. As a result, the structured so as to be an association for U.S. purposes. As a result, the Canadian limited partnership rather than the limited partners would file a U.S. tax return. It is also arguable that there would be no U.S. estate tax.
- A restaurant syndication has the advantage that it is not subject to the rental property restriction and may allow investors to claim capital cost allowances in excess of net income.

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