

INCORPORATING INVESTMENTS

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Why Incorporate?

For Ontario residents, incorporating investments will be a more interesting option in July 2010, as corporate tax rates start to decrease. There are a number of potential advantages to holding investments in a corporation, rather than holding the assets personally:

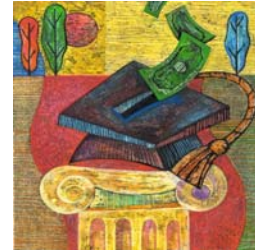
1. Estate Freeze – Investments may be transferred to a corporation on a tax-deferred basis in exchange for preferred shares of the corporation. The future growth of the investments can accrue to other individuals or to a family trust.

The preferred shares received on the transfer of the investments may be redeemed over time and will minimize the taxes payable on the transferor's death.

The optimum time for investors to implement an estate freeze is when the market values of their investments are low. At this time, the value of the preferred shares received on the transfer of the investments is lower and the taxes payable on the death of the individual are minimized.

If an individual decides not to incorporate and gives investments to a family member directly, there would be a taxable disposition, and the individual would no longer control the decisions relating to the investments.

2. Opportunities to Save and Defer Tax - The corporation and the individual are two separate taxpayers and are taxed at different rates. As illustrated in the Tax Rates section of this publication:



- There are no tax savings if an individual simply incorporates his/her investments and is the only shareholder of the corporation.
 - If there are other shareholders of the corporation, tax savings and deferrals are possible, depending on the tax brackets of the individuals involved.
 - It is often possible to save income tax through a corporation by paying dividends to low-income family members. For example, dividends can be paid to children over 18 that need money for post-secondary studies.
 - It should be noted that dividends paid to minors are taxed at the top personal tax rate.
 - Reasonable salaries can be paid to family members.
3. Flexibility of Personal Income – With many investments, such as mutual funds, income distributions can vary dramatically from one year to the next. By holding the investments in a corporation, an individual may determine in advance what their personal taxable income for a year will be. (Individuals generally know the amount of their income from other sources, such as employment or pension income). This has several advantages:

- It ensures that the low tax brackets are utilized every year. This can be achieved by a payment of salary or dividend each year.
- The reduction of Old Age Security (“OAS”) benefits can be avoided. To avoid the reduction of OAS benefits, an individual should have income of less than \$65,000 per year.

4. Probate Minimization through Dual Wills – Currently, in Ontario, the estate of an individual is subject to probate on death. The current probate rate is 1.5% of the fair market value of the portion of the estate subject to probate. Assets subject to probate include investments held personally.

By incorporating investments, an individual owns shares of one private corporation, instead of owning shares of several public companies.

The term “dual wills” means that one individual has two wills. One will deals with assets that do not require probate, such as shares in private corporations and loans to private corporations. Normally, the executors of an estate do not require probate on this will since it only deals with private company matters. The other will deals with the remainder of an individual’s estate, and would normally require probate.

5. United States Estate Tax Minimization – For an individual who dies owning U.S. property (including shares of any U.S. corporation), there may be United States Estate Taxes owing, depending on the value of the estate and the U.S. holdings.

If the U.S. investments were held by a Canadian holding company, a Canadian citizen, residing in Canada, would have no U.S. estate tax on death.

6. Asset Protection - If an individual runs into financial difficulties, paying off debts could consume all of the individual’s assets, including their investments.

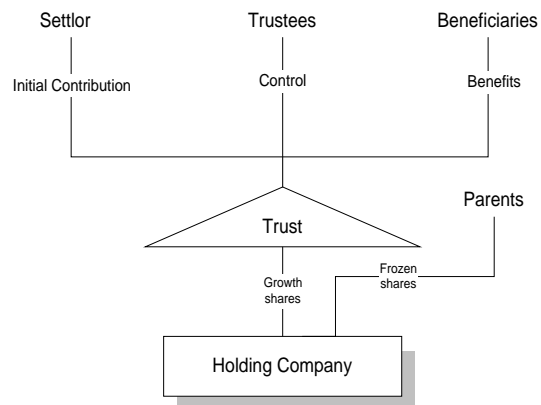
If an individual transfers investments to a holding company, and other individuals or a family trust own the common shares of the company, the future growth in the investments does not belong to the individual. Creditors will have fewer assets available to them in the event of financial difficulty.

Another method of asset protection is to gift the preferred shares received on the transfer of the assets to a family trust. Negative tax consequences, known as “attribution,” may arise on the gifting of the shares, but assets are protected.

7. Control Over Assets – On a transfer of investments to a corporation, an individual can retain control over the investments by owning voting shares of the corporation. This would allow the individual to control the assets and distributions of the company.

Share Structure

The typical structure for the use of a family trust for estate planning purposes is as follows:



Tax Rates

A benefit of holding investments within a corporation is the potential for transferring investment income to shareholders who are not in the top tax bracket.

Effective July 1, 2010, the tax rates for earning \$1,000 of interest income earned in Ontario are as follows:

Scenario 1

Income earned personally by an individual in the top tax bracket 46.41%

Scenario 2

Income earned in a corporation and dividend paid to an individual in the top tax bracket 46.06%

Scenario 3

Income earned in a corporation and dividend paid to a shareholder with less than approximately \$37,000 of income 23.22%

Scenario 4

Income earned in a corporation and retained in the corporation 46.67%

Example of taxes on \$1,000 of investment income, effective July 1, 2010

The following is an example of earning \$1,000 of interest income in a company compared with a tax-paying individual in the lowest tax bracket.

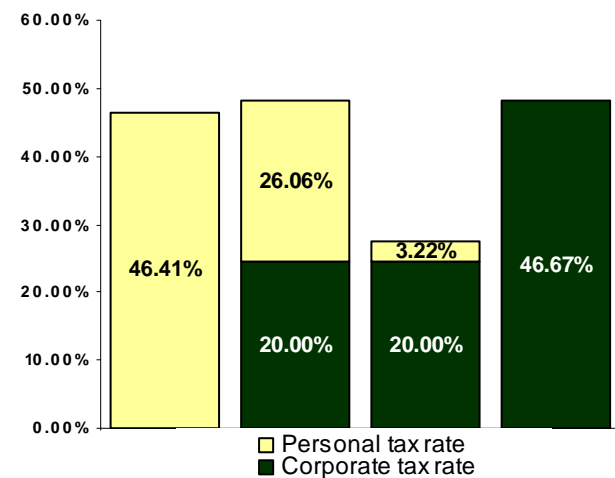
If a company earned \$1,000 of interest income, the tax treatment would be as follows:

Income earned	\$ 1,000
Corporate taxes payable - net	(200)
Dividend payment	<u>(800)</u>
Net cash in company	<u>\$ 0</u>

	Shareholder with less than \$37,000 of income	Shareholder in top tax bracket
Dividend received	\$ 800	\$ 800
Personal taxes payable on dividend received	<u>(32)</u>	<u>(260)</u>
Net cash to individual with a holding company	<u>\$ 768</u>	<u>\$ 540</u>
Net cash to individual if \$1,000 of interest income earned without a holding company	<u>\$ 790</u>	<u>\$ 536</u>

INCORPORATING INVESTMENT INCOME

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Total Tax =	46.41%	46.06%	23.22%	46.67%



This illustrates several points:

- Effective July 2, 2010, for a taxpayer in the top tax bracket, there is actually a small tax saving by incorporating (the taxpayer receives \$536 net cash without a holding company compared with \$540 net cash with a holding company). However, the additional compliance costs outweigh the tax savings.
- A holding company can save more tax if the investment income can be shifted to individuals in a lower tax bracket. If an individual in the top tax bracket incorporates their investments and a \$1,000 dividend is

paid to someone with less than \$37,000 of other income, the net personal cash of the family will increase from \$540 to \$768.

- If the individual simply gifts the investments to a family member with less than \$37,000 of other income, the net cash of the family increases from \$536 to \$790. However, most individuals do not want to lose control of assets by gifting.

Examples of an Estate Freeze

Assume that an individual's only income is from investments. The following is a typical example of the use of a corporation to hold the investments:

Fair market value of investments	\$ 3,000,000
Cost of investments	<u>2,000,000</u>
Unrealized gain on investments	<u>\$ 1,000,000</u>

- The annual return on the investments is \$150,000 of dividends.
- The investor requires the annual income to pay living expenses.
- Assume that the value of the portfolio will double in 10 years to \$6,000,000.

Option 1 – Do Nothing

Each year, the only source of income is \$150,000 of dividends. The cash flow is as follows:

Dividend income	\$ 150,000
Income taxes payable on dividends	<u>29,000</u>
Net personal cash	<u>\$ 121,000</u>

After 10 years, the unrealized gains would be \$4,000,000 (= \$6,000,000 - \$2,000,000). If the investor died, the tax liability of the estate would be approximately \$928,000.

Option 2 – Estate Freeze

The following is an example of a typical estate freeze:

- The investments worth \$3,000,000 are transferred on a tax-deferred basis to a corporation.
- On the transfer, the investor receives \$2,000,000 of debt receivable from the company and \$1,000,000 of fixed-value shares of the corporation.
- The investor's adult children purchase the growth shares of the company.
- Each year, with the \$150,000 of dividend income of the company, the company redeems \$150,000 of the investor's shares. The personal taxes payable by the investor each year are the same as in Option 1.
- In fewer than seven years, the investor would no longer have any shares remaining.
- After 10 years, the investments are worth \$6,000,000, as they were without a corporation.
- The investor still has the debt receivable from the company of \$2,000,000. The shares owned by the children are now worth \$4,000,000.
- On the death of the investor, there is no tax liability. The estate tax liability has been shifted from the investor to the children.
- The taxes payable of \$928,000 that would have been payable on the death of the investor are now deferred until the death of the children.
- If desired, the children can do the same estate freeze once their children are over 18.

Other Issues to Consider

1. Extracting Funds from the Corporation

There are a number of possible ways to extract funds from a corporation:

- Any loans payable to a shareholder can be repaid. This includes promissory notes payable to the shareholder from the transfer of investments to the corporation.
- The after-tax income of the corporation may be used to pay a taxable dividend to shareholders. If the dividends were paid to low income adult shareholders, it would ensure that the low income tax brackets of family members are utilized.
- The after-tax income of the corporation may be used to redeem shares. This will reduce the individual's assets and eventual estate tax liability. If the planning is done properly, a tax refund to the corporation will offset the personal taxes payable on the share redemption.
- The shareholders may be paid a salary from the corporation. This would allow the individuals to take advantage of the low tax brackets, as well as create RRSP contribution room. The savings from paying a salary may be reduced by payroll costs such as Canada Pension Plan, Employment Insurance, and Ontario Employer Health Tax. For salaries paid to family members, care must be taken to document their duties, and the salary must be reasonable in the circumstances.
- Income may be left and taxed in the corporation. Salaries or dividends do not have to be paid each year. Payment of salaries or dividends may be left to a later date. This is advantageous if an individual's other income is expected to decline in future years.

2. Dividends received from Public Companies

In 2006, new rules came into effect for dividends received from public companies. If an individual receives a dividend directly from a public company ("eligible dividend"), the dividend is now taxed at a lower rate (for Ontario residents, the maximum tax rate on these dividends in 2010 is 26.57% compared with the rate for most private companies of 32.57%).

If a holding company receives an eligible dividend instead of an individual, the low tax rate on the eligible dividend can be flowed out to the individual shareholder, if desired. The shareholders must be notified in advance that the dividend they are receiving is an eligible dividend. Several issues arise relating to eligible dividends:

- The savings from an eligible dividend depends on the tax bracket of the shareholder receiving it. Tax planning can be done to ensure that the shareholder receiving the dividend saves the most tax for the group.
- Alternate minimum tax is increased if large eligible dividends are paid.
- Old Age Security benefits are clawed back more rapidly with the eligible dividends.

3. Trusts and Associated Company Issues

If the shares of a company are owned by a discretionary family trust, each beneficiary is deemed to own 100% of the shares that are owned by the trust. If beneficiaries have companies of their own, being a beneficiary of a trust may cause the companies to be associated for income tax purposes. This may adversely affect several income tax provisions, such as the elimination of small business deductions for the respective companies.

4. Income Attribution Rules

In the Income Tax Act, there is a complex set of rules dealing with income attribution.

Income attribution may arise when an individual transfers investments to a corporation and confers a benefit on a spouse or minor children. If attribution applies, a taxable benefit would be added to the income of the individual who transferred the investments to the corporation. In addition, the corporation must still pay the same tax on the income generated by the investments.

When transferring assets to a corporation, care must be taken to ensure that attribution will not apply.

5. Land Transfer Tax on Real Estate Investments

If the investments include real estate, Ontario imposes land transfer tax on a transfer to a corporation. The land transfer tax rate is currently 0.5% of the first \$50,000 and 1.5% of the remaining fair market value of the property.

6. Non-resident Issues

If an individual became a non-resident, there would be a deemed disposition of the assets on becoming non-resident, and income taxes would be payable.

If investments are held in a private corporation, the CRA may allow an individual to post the shares of the company as security. The income taxes must be repaid with interest within ten years of departure.

If a corporation is owned by a family trust, there are potential foreign tax issues if a beneficiary became a non-resident. Also, if some or all of the trustees of a trust became non-residents, a company could lose its status as a Canadian-controlled private corporation.

7. Choice of Year End

A new corporation must pick a year end within 53 weeks from the date of incorporation. For investment companies, a December 31st or January 1st year end is often the most convenient, since all investment reporting, such as T5 and T3 slips, are done on a calendar basis. However, there are also advantages to having off-calendar year ends. The year end of the corporation should be discussed with your accountant prior to incorporation.

8. Costs of Incorporation and Reporting Requirements

There are legal and regulatory costs to incorporate the company. There are legal and accounting fees to transfer the investments to the corporation. There are also annual costs associated with maintaining the corporate minute books, preparing the company's annual financial statements, and preparing the corporate tax returns (both federal and provincial).

Investors should consider and review the potential benefits of incorporation with their professional advisors.

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