



Newsletter

Fall 2006

GET A “GRIP”—NEW RULES ON DIVIDENDS CHANGE TAX PLANNING

Generally, the new rules will make it more attractive to pay dividends instead of salaries, especially when payroll costs such as CPP and EI are considered.

Changes are proposed to the tax rates on dividends in order to level the playing field between corporations and income trusts. Prior to these rules, Quebec shareholders of all public companies and certain Canadian-Controlled Private Corporations (CCPCs) were paying a total of approximately 54% in tax between the company and the shareholder receiving the dividend. Income Trusts became very popular because they eliminated the corporate portion of the income tax, and the highest tax rate became 48%, instead of 54%.

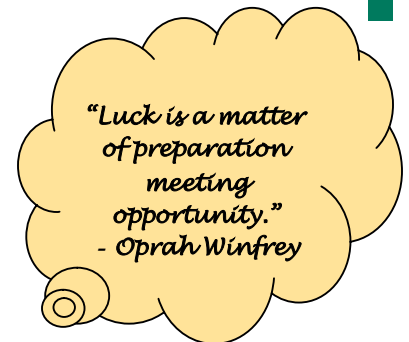
For CCPCs, the new rules can be summarized as follows:

- A new General Rate Income Pool (“GRIP”) has been created to track active income that has been taxed at the top corporate rate. Companies can have an opening GRIP balance in 2006 for income earned from 2001 to 2005 that was taxed at the top corporate rate in those years. The GRIP addition is reduced by any taxable dividends paid in those years.

- Dividends paid out of the GRIP in 2006 or later are taxed at a lower rate. In 2006, for Quebec residents, the top tax rate on dividends paid out of the GRIP will be 29%, compared to 36% for other dividends.
- For Quebec residents, the total combined corporate and personal tax on GRIP dividends will be 50%.
- When a dividend is paid, companies must tell shareholders if a dividend is a GRIP dividend. Tax savings are possible by paying GRIP dividends on one class of shares and non-GRIP dividends on another class of shares.
- To date, several provinces have indicated that they will follow the federal government’s lead in reducing tax rates on GRIP dividends.

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Special points of interest:

- *Personal tax instalments:*
 - Dec. 15, 2006
 - Mar. 15, 2007
 - Jun. 15, 2007
 - Sept. 15, 2007

LIFE INSURANCE CAN BE A GREAT INVESTMENT

Life insurance is a financial instrument whereby the owner pays premiums for a future payout based on the death of an individual.

A Term to a Specific Age policy is generally used to insure for a defined liability which could occur prior to the termination date. The most common need is the cost of raising a family.

These policies usually have:

- a termination age (65-80 years), at which time the payout is no longer required,
- an escalating premium, and
- options to convert to a Term for Life policy or to increase the amount of the policy without a medical examination.

Term for Life policies are regarded as more of an investment. These policies have no termination age, as long as the premiums are paid. Usually the maximum payments are made to age 95 or 100. The insurance pays out on the death of the individual. A simple example of the investment aspect would be a 40 year-old male who would pay about \$5,000 a year for \$1,000,000 of life insurance. At age 80, which is his standard mortality age, he would have paid premiums totalling \$200,000. The compounded rate of return would be 7%. (This is after receiving free insurance for a premature death.)

The Term for Life policies have fixed premiums per year. It is expected that the policy will be maintained to maturity. The premiums can be prepaid. One needs to consider the guaranteed (vs. non-guaranteed) rates of return on excess funds put into a policy.

Additional investment funds can be added to certain policies. The investment income is not taxed until it is withdrawn from the policy.

If the investment income is withdrawn on the death of the individual, the amount is tax free as insurance policy proceeds.

Sophisticated planning allows a company to invest in a life policy at about an 8% guaranteed rate and borrow money from a related lender at a guaranteed rate of about 10%. The tax-free investment income of the policy vs. the tax-deductible interest expense will result in a substantial after-tax saving.

As a general rule, where a company exists, it should own the life insurance so that the premiums are paid in corporate dollars before personal income taxes. Life insurance proceeds are tax free to the company and will generally flow tax free through to the shareholders.

The capital dividend account generated by the life insurance proceeds (net of adjusted cost base) can reduce the gain on shareholder shares, if the tax-free dividend from the capital dividend account is used to buy back some of the shares.

Life insurance is a complex area when applied to the income tax rules. The alternatives and benefits are endless, and can provide substantial investment returns and tax savings.



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WHAT IS A REASONABLE BONUS?

Bonuses are a major planning tool related to compensating family members and managing the overall income taxes of the corporation and the individual. Bonuses are used to maximize the usage of the small business rate and to utilize low marginal rates of family members who contributed to the business, maximize RRSP contribution room, make CPP contribution room, etc. A bonus must be paid within 179 days of the year end of the company to be deductible. The CRA says payment (as a minimum) is the remittance of withholding taxes as required. In the past year, we have seen a number of audit approaches, CRA interpretations, and legislative proposals that have changed the strategies.

Audit approaches of the CRA include a review of bonuses requiring detailed justification of bonuses paid to family members, suggesting it is a directed payment by the shareholder and taxed in that individual's hands, leaving the amount in the family member's income, and disallowing the deduction to the company. Compensation to family members is less visible to the CRA audit if they are on normal payroll at a reasonable amount and not paid as a bonus.

The CRA's reasonable test of bonuses paid to shareholders can be summarized as follows:



- A bonus from active profits (including the sale of operating assets) to an active shareholder is not subject to the reasonableness test.
- A bonus from inactive profits (including the sale of investment assets or shares of an active business company) is subject to a reasonableness test of all shareholders.
- A bonus from any profits to an inactive shareholder is subject to the reasonableness test.

The proposed legislative changes to the taxation of dividends should result in the total combined taxes of a corporation and an individual on the dividend at about the same as the tax on the salary paid to an individual. One will now have to consider the following:

- Pay salary to manage CPP, RRSP, and Child Care deductions.
- Where income is not required for personal living costs, tax profits at the corporate level in order to maximize deferral of tax.
- Determine if six-months' tax deferral of tax on the bonus is important.
- Pay dividends where there is any reasonableness of salaries issue. Generally, the CRA has permitted separate share classes with separate dividend amounts. The preferred solution is a discretionary family trust, which owns the common shares, where the dividend allocation is decided by the trustees, and is, therefore, not subject to the reasonableness test. However, the Kiddie Tax, applicable to private corporation dividends paid or allocated to children under 18, must be considered.

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UNIVERSAL CHILD CARE BENEFIT

Effective July 2006, the Canada Child Tax Benefit has been replaced by the new federal Universal Child Care Benefit (UCCB).



The initial goal of this new program is to support all families equally, regardless of their circumstances (e.g. single-parent families versus two-parent families) and to let them decide the best way to use those funds for their family. The UCCB pays monthly instalments of \$100, for a total of \$1,200 per year, for each child under the age of 6 years. Eligibility criteria exist relating to citizenship, residency and the relationship with the child. These criteria can be obtained through the Canada Revenue Agency’s website—<http://www.cra-arc.gc.ca/benefits/uccb/faq-e.html>.



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TAX CREDIT FOR PUBLIC TRANSIT PASSES

Beginning July 1, 2006, individuals are eligible for a non-refundable tax credit to cover the cost of public transit passes. The tax credit will apply to monthly (or longer duration) passes that are purchased after June 30, 2006, for commuting on buses, subways, commuter trains and local ferries.

Support for the term of the pass, the period for which the pass is valid, the name of the transit authority or organization issuing the pass, the amount paid for the pass and the identity of the rider must be displayed on the pass itself if it is to be used as support or a claim.



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