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Understanding Investment Holdco Financial Statements in the Context of Post Mortem Planning

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Audit.Tax.Consulting.Financial Advisory.

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Death of a taxpayer

- Deemed disposition on death of all capital property at its fair market value

- Beneficiaries receive property at fair market value of property immediately before death

- In the case of a surviving spouse there is an automatic "rollover" of assets at cost to the surviving spouse, unless an election is made to elect out of the automatic rollover

Death of a taxpayer case study assumptions

- Assumes no surviving spouse; therefore, deemed disposition of all capital assets on death

- Assumes deceased taxpayer was sole shareholder of private company shares

- Will consider Holdco with portfolio investments that have accrued gains

Deemed disposition of private company shares

Overview of Issues

- Double taxation
- Post mortem planning strategies

Basic Tax Concepts

Relevant tax attributes

- Refundable tax on hand (“RDTOH”)
- Capital dividend account (“CDA”)
- General rate income pool (“GRIP”)
- Adjusted cost base (“ACB”) vs. paid up capital (“PUC”)

Other considerations in post mortem planning

- Intentions of the beneficiaries
- Nature of corporate assets and tax balances

Post mortem planning cont'd

Where can relevant tax attributes be found?

- Financial statements?
- Notes to financial statements?
- Corporate tax returns?
- Other?

Sample Investment Holdco Financial Statements

MJ Holdings Inc.
Balance Sheet as at October 31, 2009

	2009 $
ASSETS	
Current	
Cash	1,100
Investment in Beatles Inc (publicly traded)	100,000
	101,100
LIABILITIES	
Current	
Accounts payable	1,000
	1,000
SHAREHOLDER'S EQUITY	
CAPITAL STOCK (Note 2)	100
RETAINED EARNINGS	100,000
	100,100
	101,100

MJ Holdings Inc.
Income Statement for the year ended October 31, 2009

	2009 $
DIVIDEND INCOME	10,000
	10,000
EXPENSES	
Interest and bank charges	100
Office and general	8,900
Professional fees	1,000
	10,000
NET EARNINGS	-
RETAINED EARNINGS beginning of year	100,000
RETAINED EARNINGS end of year	100,000

MJ Holdings Inc.
Notes to Financial Statements - October 31, 2009

1) The Company, with the consent of its sole shareholder, has elected to prepare its finacial statements in accordance with GAAP

2) **Capital Stock**

Authorized

Unlimited common shares

Unlimted Class A preferred shares

Issued	2009 $
100 Common shares	100

3) **Refundable Dividend Tax**

Pursuant to the Income Tax Act, the company is classified as a Canadian-controlled private corporation, so that certain taxes paid on the company's investment income are refundable at the rate of $1 for each $3 of taxable dividends paid. The balance of refundable tax on hand at the end of the year was $20,000.

Post mortem planning cont'd

Where can relevant tax attributes be found?

- Financial statements provide minimal information with respect to the relevant tax attributes outlined; therefore, we would need to consider other sources

- A general understanding of some of the relevant tax attributes and other relevant considerations would useful; thus, a brief discussion on each topic would be appropriate

Refundable Dividend Tax on Hand

- Applicable to private corporations
- Consists of two parts:
  a) Refundable tax on investment income (other than dividends) of a Canadian Controlled Private Corporation (CCPC)
  b) Special tax on dividends received by a private corporation from certain taxable Canadian corporations
- RDTOH is refundable at a rate of $1 for every $3 of taxable dividends paid by the private corporation to its shareholders

Refundable Dividend Tax on Hand cont'd

Refundable Part 1 tax:

- Only applicable to CCPCs and is generally equal to 26.67% of total aggregate investment income (excluding dividends) earned in the CCPC
- Assume a CCPC earns $1,000 of passive interest income, $267 will be added to the corporation's RDTOH balance, which could then be refunded to the corporation upon payment of sufficient taxable dividends

Refundable Dividend Tax on Hand cont'd
Refundable Part 1 Tax example:

Interest income	$1,000
Less: Corporate taxes payable*	 $487
Net income	**$513**

Amount added to RDTOH:	
Aggregate investment income	$1,000 x 26.67%
RDTOH	**$267**

Refundable Dividend Tax	
Taxable dividends paid to shareholders Dividend tax refund to corporation: Lesser of: •RDTOH balance - $267 •1/3 of taxable dividends paid - $173	$513 $173
Net tax paid by the corporation:	**$314**

* Assumes Federal and Ontario corporate tax rates in 2009, including refundable Part 1 tax

Refundable Dividend Tax on Hand cont'd

Part IV tax:

- Imposed on private corporations on dividends received from non-connected (i.e. portfolio dividends) and connected corporations
- Part IV tax is computed as the sum of:
  a) 33 1/3 % of assessable dividends received; and
  b) Proportionate % of dividend refund received by connected corporations

Refundable Dividend Tax on Hand cont'd

Refundable Part IV Tax example:

Part IV – portfolio dividends:	
Portfolio dividends received	$1,000 x 33.33%
Part (a)	**$333**

Part IV – Connected Corp:	
% of shares held of connected corporation Dividends received from connected corporation Dividend refund received by the connected corporation Part IV payable: Lesser of: a) 33.33% of assessable dividends rec'd – i.e. 33.33% x $1000 = $333 b) % of dividend refund rec'd by payer – i.e. 50% x $200 = $100	50% $1,000 $200 $100
Part (b)	**$100**
Total amount added to RDTOH: (a) + (b)	**$433**

Refundable Dividend Tax on Hand cont'd

Where can we locate RDTOH balance?

- In certain circumstances RDTOH is disclosed in the notes to the financial statements

- For greater certainty, RTDOH can be located on the jacket of the corporate tax return, specifically page 6 of the jacket, line 485.

Capital Dividend Account

- Applicable to private corporations resident in Canada
- Made up of the following amounts:
  a) Non-taxable portion of net capital gains realized by the corporation;
  b) Capital dividends received by the corporation, less capital dividends paid by the corporation;
  c) Life insurance proceeds paid out to the corporation (net of the policy's adjusted cost base)
- The CDA balance is calculated at a point in time and can be paid out to Canadian resident shareholders without incidence of tax
- There is a requirement to file an election – Form T2054

Capital Dividend Account cont'd

CDA example:	
Capital gain realized in a CCPC	$2,000
Taxable capital gain (i.e. 50% inclusion rate)	$1,000
Corporate tax payable (@ 48.67%)*	$487
RDTOH addition (i.e. 26.67% of aggregate investment income)	$267
Amount added to CDA (i.e. non-taxable portion of capital gain)	$1,000
Dividends payable to shareholders: (a) Taxable Dividends (b) Non-taxable capital dividend	 $780 $1,000
Net corporate tax paid after refund of RDTOH	$220
Total personal tax paid on dividends (@31.34%)**	$244

* Assumes Federal and Ontario corporate tax rates in 2009, including refundable Part 1 tax

** Assumes shareholder in highest tax bracket in Ontario for 2009 on ineligible dividends

Capital Dividend Account cont'd

Where can we locate the CDA balance?

- There may be a worksheet attached to the corporate tax return that provides a continuity of Capital Dividend Account that may provide the balance in the CDA
- However, it is advisable that a proper calculation of CDA be carried out by a tax advisor given the consequence of electing to pay a capital dividend in excess of the CDA balance
- A detailed calculation involves looking at the history of gains and losses incurred by the corporation, in addition to any capital dividends either paid or received by the corporation

General Rate Income Pool

- Only applicable to CCPCs
- Essentially relates to full rate income earned by the corporation
- Does not include investment income earned by the corporation
- Dividends paid out of GRIP (i.e. eligible dividends) receive preferential tax treatment in the form of an enhanced dividend tax credit
- Eligible dividends must be designated as such at the time of payment
- GRIP is calculated at the end of the corporation's taxation year

General Rate Income Pool cont'd

GRIP example:	
Income taxable at the general corporate rate	$1,470
Corporate tax payable @ 33%*	$485
After-tax income available for distribution	$985
Addition to GRIP:	
68% multiplied by income taxable at the general rate	$1,000
Planning opportunity: Assume existing RDTOH Corporation pays an eligible dividend to recover RDTOH	 $333 $1,000
Tax recovery in CCPC	$333
Total personal tax paid on dividend @ 23.06%**	$231
Net tax recovery	**$102**

* Assumes combined Federal and Ontario corporate tax rates for 2009

** Assumes Ontario resident shareholder in highest marginal tax bracket for 2009

General Rate Income Pool cont’d

Where can we locate the GRIP balance?

- GRIP is calculated on Schedule 53 of the corporate tax return
- GRIP at the end of the year is located on line 590 of Schedule 53
- As noted, GRIP is an “end of year” calculation therefore prior year’s ending GRIP balance should be added to any GRIP earned in the current year

Adjusted Cost Base vs. Paid up Capital

- PUC relates to a specific class of shares issued from treasury and is based on the amount contributed to the corporation
- PUC is calculated at the corporate level and is calculated separately for each class of shares issued
- Total PUC for each specific class is averaged over that class
- A shareholder can always have PUC returned tax free
- ACB relates to specific shareholders and is based on the amount paid for their respective shares
- ACB is used to determine a gain or loss on the disposition of shares

Adjusted Cost Base vs. Paid up Capital cont'd

ACB vs. PUC example:

- On January 1, 2010 XYZ issues 100 common shares to Mr. X for $100;
- On October 1, 2010, XYZ issues an additional 100 common shares to Mr. Y for $1,000.

ACB vs. PUC:

- On January 1, 2010 Mr. X's PUC = ACB = $1/share
- On October 1, 2010 Mr. X's & Mr. Y's PUC = $5.5/share; however, Mr. Y's ACB = $10/share

Adjusted Cost Base vs. Paid up Capital cont'd

Paid up Capital	Adjusted Cost Base
Calculated at the corporate level	Calculated at the shareholder's level
Based on amounts contributed to a corporation	Based on amounts individuals pay for respective shares
Averaged over the class of shares	Unique to each shareholder
Can generally be withdrawn tax free at any time	Used to consider gain/loss on disposition of shares

Post mortem planning: Other considerations

Intentions of the beneficiaries

- Nature of post mortem tax minimization planning will depend on the intentions of the beneficiaries:
  - Anticipating the sale of shares at the Investment Holdco level?
  - Anticipating to hold the assets for an extended period?

Post mortem planning: Other considerations

Nature of corporate assets and tax balances

- Corporate assets consist of mainly depreciable assets – i.e. buildings, equipment etc., or non-depreciable assets – i.e. portfolio investments, land etc.

- Does the corporation have RDTOH, CDA, GRIP?

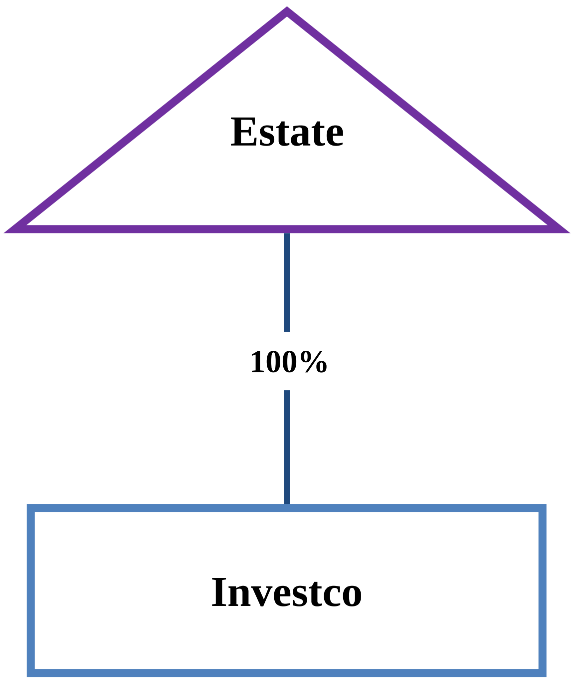
Deemed disposition of private company shares

Double Taxation on Death

- Issue arises where
  - Estate pays tax on deemed disposition of shares
  - Company owns assets with accrued but unrealized gains
- Avoided if there's a surviving spouse
- Mitigated if estate subsequently sells shares of corporation, or if assets are held in corporation for an extended period of time

Deemed disposition of private company shares

Double Taxation example:



FACTS:

1)Testator owns fixed value preferred shares;
2)FMV of shares is $101
3)ACB of shares is $1
4)Investco owns portfolio investments;
5)FMV of portfolio is $101
6)ACB of portfolio is $1

A)Tax on terminal return:

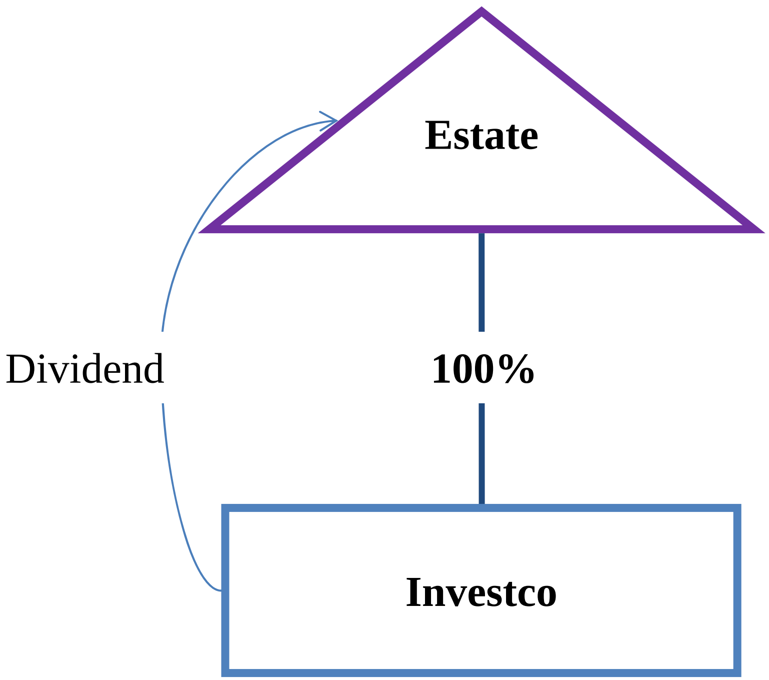
FMV	$101
ACB	($1)
Capital Gain	$100
Tax @ 23.20%	**$23**

B) Tax on sale of assets by Investco:

FMV	$101	
ACB	($1)	
Capital Gain	$100	
Taxable capital gain	$50	(50% inclusion)
Tax @ 48.67%	$24	
RDTOH	($13)	(26.67% of TCG)
Net corporate tax	**$11**	
Remaining for distr.	**$90**	**($101-$11)**

Deemed disposition of private company shares

Double Taxation example cont'd:



C) Tax on distribution to shareholder:

Return of capital	$1	
Capital dividend	$50	
Taxable dividend	$39	($100 - $11 - $50)
Personal tax on dividend*	**$12**	

D) Total tax paid on $100 gain:

Tax on death	$23
Corporate tax	$11
Personal tax on redemption	$12
Total taxes paid	**$46**

* **Assumes top marginal rate in Ontario, on ineligible dividends – i.e. 31.34%**

Deemed disposition of private company shares

Planning alternatives

- As illustrated in our example, main tax exposure inherent at death is double taxation
- Planning available
  - Depends on the nature of company; assets; future intention of surviving shareholders
- Complicated process depending on tax attributes
  - RDTOH/CDA/GRIP/non-depreciable capital property
- Two alternatives will be considered:
  - Subsection 164(6) “Loss Carry-back”
  - Paragraph 88(1)(d) “Bump”

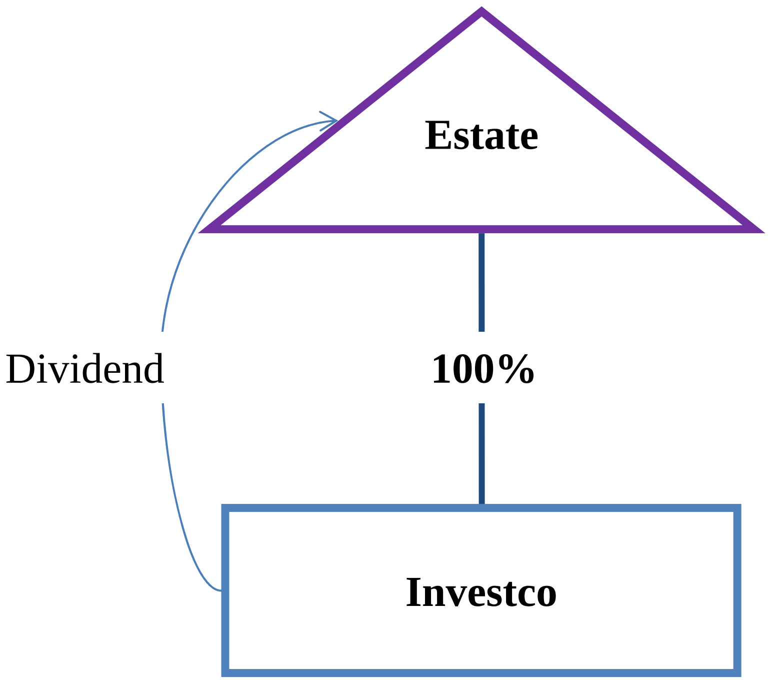
Post Mortem Planning

Subsection 164(6) “Loss Carry-back”

- On death the assets of deceased are transferred to the executor at fair market value
- Assets received by executor may be sold during the administration of the estate potentially resulting in a gain or loss to the estate
- Subsection 164(6) is designed to allow the executor to elect to report any capital and/or terminal losses realized in the first year of an estate on the final return of the deceased
- Deems the loss to be a loss of the deceased taxpayer in the taxpayer’s last taxation year

Post Mortem Planning cont’d

Subsection 164(6) “Loss Carry-back” example:



Continuing with the previous fact pattern :

Potential recovery of tax if capital loss carried back:

Deemed proceeds of disposition:	$1
ACB of Investco Shares:	($101)
Capital loss	**($100)**

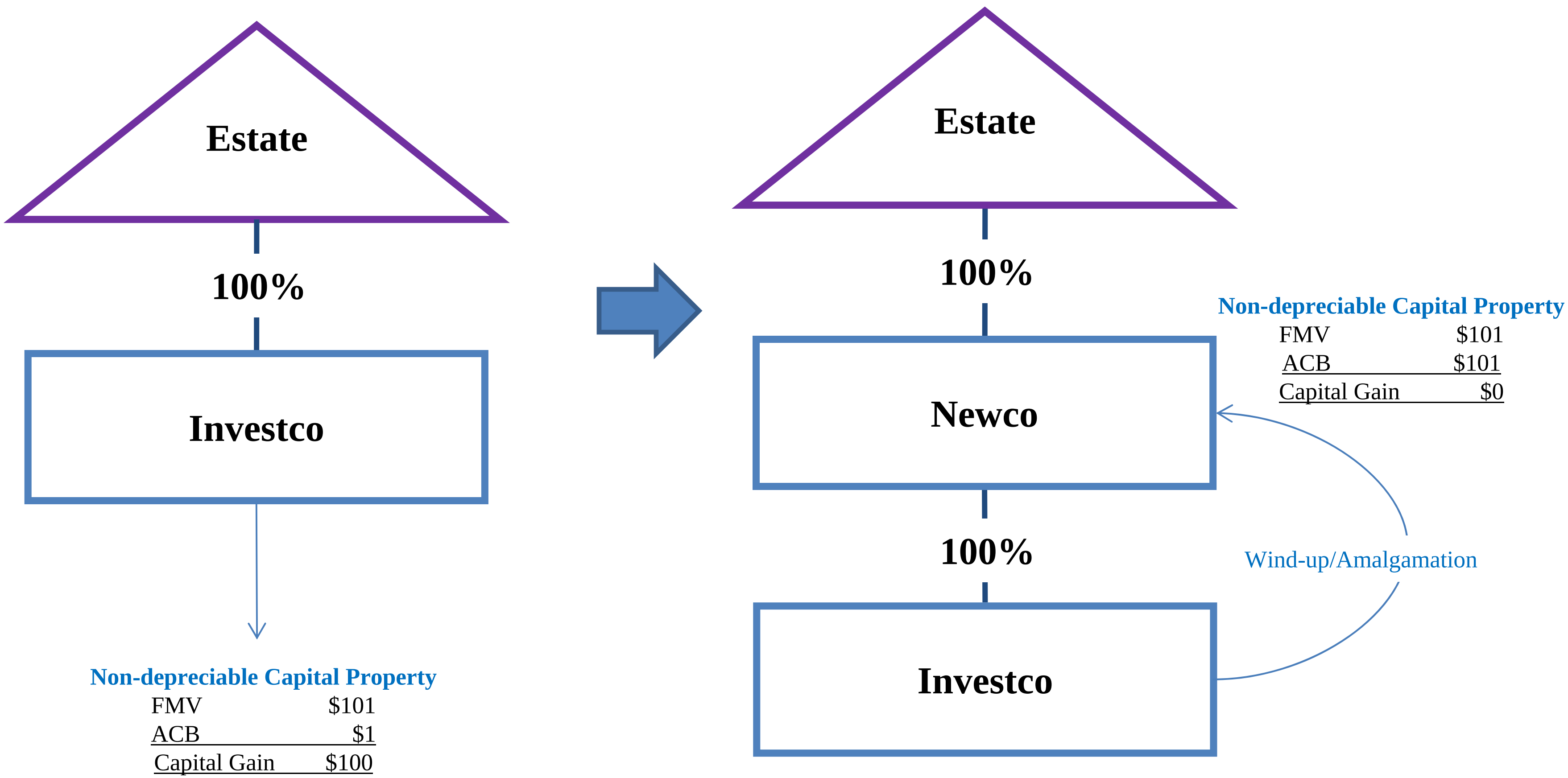
Potential tax recovery of tax @ 23.20% $23

Total tax paid on $100 gain:

Tax on death	$23
Corporate tax	$11
Personal tax on redemption	$12
Tax recovered	($23)
Total taxes paid	**$23**

Post Mortem Planning cont’d

Paragraph 88(1)(d) “Bump” Planning:



Summary

- Post mortem planning is a misnomer – really pre-mortem planning for post-mortem implementation; i.e. planning today for tomorrow
- Financial statements provide limited information relating to the information required to implement post-mortem planning – remember to consult tax returns and assessments, in addition to speaking with beneficiaries
- Double taxation is the most relevant tax exposure inherent on death, however, there are various alternatives available to mitigate the impact of double taxation – i.e. 164(6) loss carry-back planning, and 88(1)(d) bump planning
- Be wary of potential traps and pitfalls – i.e. stop loss rules

Questions?

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