



# Newsletter

December 2005

## LIFE INSURANCE & SUCCESSION PLANNING FOR SHAREHOLDERS OF PRIVATE COMPANIES

Amendments to the *Income Tax Act* relating to life insurance and succession planning have resulted in some restrictions that could markedly increase the ultimate tax liability of a deceased shareholder of a private holding company or incorporated business. The following is a summary of the “Old Rules,” and the implications of these “New Rules.”



### The “Old Rules”

Upon death, the general rule is that there is a deemed sale at fair market value (FMV) of all property owned (including shares of private companies), resulting in any unrealized gains being

taxed at that time. The property transferred to the deceased’s estate will then have a tax cost equivalent to its FMV. Under the “Old Rules” (assuming the shareholder’s company had adequate life insurance), life insurance proceeds could be used to repurchase the shares held by the estate, triggering a tax-free capital dividend and a capital loss.

The capital loss realized by the estate upon repurchase of the shares could be carried back to the terminal return of the shareholder such that all or most of the gains realized on the deemed sale of the company shares could be eliminated. In essence, the estate of the deceased could effectively cash out the FMV of the deceased’s shares tax-free.

### The “New Rules”

Under the “New Rules,” the capital losses realized

by the estate may be “reduced” upon the receipt of the tax-free capital dividend, as determined by a specific formula. As a result, what was formerly a tax-free (or near tax-free) buy-out can now result in a severe tax liability to the estate.

### Planning Opportunities

Despite the implications of these amendments, certain “grandfathering” provisions exist which may exempt you from the “New Rules.” (Caution: Redoing your shareholder agreement could void the “grandfathering” provisions.)

In order to ensure your succession and estate plan is optimized, it is strongly advised that you consult with your tax advisor to see if these exceptions apply to you. Even if these provisions aren’t applicable, there may be other options available to you to reduce the overall tax burden.

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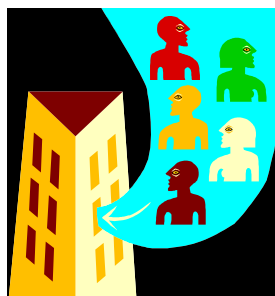
*“Begin with the end in mind.”*

— Stephen Covey

### Special points of interest:

- *Next personal tax instalments:*  
- Dec 15, 2005  
- March 15, 2006

## IS YOUR CORPORATION REALLY A BUSINESS? THE CRA MAY DISAGREE....



**The CRA uses many factors to determine whether a corporation is a personal services business.**



In our Spring 2005 issue, the article, “Employee or Independent Contractor,” noted that the Canada Revenue Agency (CRA) is reviewing whether individuals are employees or independent contractors.

What happens if the self-employed business is a corporation instead, doing the same job that an employee could do? If so, the rules about “personal services businesses” (also known as the “incorporated employee”) should be reviewed.

Many employees would like to incorporate because, under the *Income Tax Act*, employees cannot deduct many expenses. Also, tax savings can be achieved in many ways through incorporation:

- The lower tax brackets of other family members can be utilized if they are shareholders of the corporation.
- Taxes can be deferred if active business income is left in the corporation (in Alberta, the corporate tax rate is 16.12% on the first \$300,000 of income and 25.12% on the next \$100,000 of income).
- The amount of personal taxes that eventually must be paid can be reduced by paying the shareholder in a low-income year, such as during retirement.

In recent years, the CRA has won several court cases, arguing that a corporation was simply an “incorporated employee,” and should not get the benefits of carrying on a business through a

corporation.

An incorporated employee does not qualify for the small business deduction and is, therefore, subject to tax at the highest corporate rates (in Alberta, this is 33.62%). In addition, most expenses are not deductible, except for:

- Salary and benefits paid relating to the “incorporated employee.”
- Expenses that would have been deductible in computing employment income if the worker had been an employee.

This issue is on the CRA’s list of potential tax audit areas. For a detailed summary, see the CRA’s publication at <http://www.cra-arc.gc.ca/E/pub/tg/rc4110/rc4110ed.html>.

The following is a list of some of the factors that the CRA may use to determine whether a corporation is a personal services business:

- The worker provides services for only one customer.
- The customer has the right to control the amount, nature, and direction of the work to be done.
- The customer furnishes the tools, materials, and facilities.
- There is a requirement that a worker must work specified hours.
- The customer pays the worker’s expenses directly.

If you think that this may apply to you or someone you know, please contact

**For a detailed summary, see the CRA’s publication at <http://www.cra-arc.gc.ca/E/pub/tg/rc4110/rc4110ed.html>.**

## LUCRATIVE TAX REFUNDS FROM SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT (SR&ED)

In today's changing world, business has become more competitive. The result is that many Canadian businesses must devote significant resources to the development of new products and processes.

The Canadian government encourages Canadian businesses to be more productive by investing resources in scientific research and experimental development (SR&ED). As a result, the tax benefits for SR&ED activities carried on in Canada are among the most generous SR&ED incentives in the world.

### Cash Refunds

When correctly planned, the SR&ED program can result in **significant tax refunds** for a Canadian-controlled private corporation (CCPC). There is a 35% refundable Federal investment tax credit on qualifying SR&ED expenditures to a maximum of \$700,000 in cash. In addition, there is a 10% refundable Ontario innovation tax credit on qualifying SR&ED expenditures to a maximum of \$200,000 in cash. Other non-CCPC businesses can also qualify for reduced tax credits.

Many eligible businesses are not filing claims, as they are unaware of the program. Therefore, they are missing the significant tax benefits from SR&ED. The increase in cash flow from SR&ED can be utilized in many areas of a business, including expansion into new markets or products, hiring additional employees, purchasing additional capital equipment, or payment of shareholder loan balances.

### Are You Performing SR&ED?

Businesses in all industries should consider the benefits of SR&ED. Qualifying companies include engineering firms, farms, food processors, bakeries, and testing labs - to virtually any manufacturing or processing company. A company does not have to be in a "high-tech" industry to be involved in SR&ED.

A business may qualify for SR&ED benefits if it:

- Develops new products or improves existing products.
- Improves the methods to produce an existing product. (For example, the development of an improved manufacturing technique or process to enhance product quality or reduce production costs.)
- Improves the environmental impact of the manufacturing process. (This could include developing techniques to reduce pollution or waste.)
- Creates custom machinery or uses new materials.
- Creates innovative software, e-business solutions, or web-enabled applications.

### Qualifying Expenditures

If a company qualifies for SR&ED, the related costs qualify for the lucrative SR&ED tax incentives. These include wages, materials, contract costs, capital expenditures, and overhead.

### The Next Step

An SR&ED claim is filed as part of your corporate tax return. The government allows an additional year from the regular corporate filing deadline to file the SR&ED claim. Accordingly, this often enables a corporation to go back an extra year to file its SR&ED claim.

A successful SR&ED claim can provide a significant increase in cash flow to your business and enhance your technological capabilities and competitiveness. Many of your competitors may be taking advantage of the SR&ED program and your company should too!

We would be pleased to discuss with you the applicability of SR&ED to your business.



**When correctly planned, the SR&ED program can result in significant tax refunds for a Canadian-controlled private corporation.**



THE **A B C** 'S OF **P S T** ARE CERTAINLY NOT ELEMENTARY!

A common myth is that provincial sales tax (PST) is only applicable on “end-user” retail items. PST legislation has increased the number of areas where PST applies. Negligence in understanding PST could result in costly interest charges and penalties.

Here are **some** common areas targeted by auditors in the provinces that impose PST – Prince Edward Island, Ontario, Manitoba, Saskatchewan and British Columbia.

- Many purchasers believe that out-of-province purchases are exempt from PST. Not always! It is the purchaser’s responsibility to self-assess the tax on out-of-province purchases.
- Out-of-province sales could be caught by PST/HST if you have a “presence” in the province (i.e., Alberta sales and deliveries to Ontario). A presence could include a branch office, warehouse, post office box, employees, agents, etc.
- PST collected must be remitted by the due date of the return. Interest and penalties may be levied for late filing or non-remittance, if the failure to remit is determined a wilful act.
- Goods purchased for resale are exempt from PST; however, PST is applicable on goods taken from inventory for company use.
- Companies cannot use their vendor tax numbers to purchase items and equipment on a PST-exempt basis, if these items are for company use.
- Companies must collect applicable PST on the sale of non-inventory items, i.e., fixed assets.
- Companies should keep supporting documents for exempt sales to prove they properly accounted for PST on all sales (including out-of-province shipments). Otherwise, vendors can be assessed for failure to collect the tax.



For more Ontario PST information, visit [http://www.trd.fin.gov.on.ca/userfiles/page\\_attachments/Library/3/Rsie\\_sb901.pdf?N\\_ID=3](http://www.trd.fin.gov.on.ca/userfiles/page_attachments/Library/3/Rsie_sb901.pdf?N_ID=3).



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