Collins Barrow
Chartered Accountants

Tax Alert

FALL 2005

Should You Put Your Investments Into a Corporation?

Taxpayers who own a large stock portfolio or rental property investments often ask whether putting those investments into a personal holding company would save tax.

Corporations can own stocks, bonds, mutual funds and rental properties. Taxpayers could set up their own company and transfer their investments into it. But would this make sense?

For most taxpayers, the answer is probably "no." Corporations pay tax just like individuals do, and the corporate tax rate on investment income is high. In Ontario, for example, interest income and rental income earned by a private company attract an initial tax rate of about 50%. In contrast, the top personal tax rate is about 46%.

There is also a second layer of personal tax when that income is withdrawn from the company. At that time, the company receives a partial refund of the tax it has paid, to offset the personal tax and eliminate double-taxation. Thus, the combined net corporate and personal tax on investment income earned by a private holding company and paid out to the shareholder is almost identical to the personal tax that would be paid if the income had been earned personally.

Some other disadvantages include the costs to incorporate, ongoing fees to maintain the company and file tax returns, and the need to separate corporate and personal transactions carefully. Tax issues also arise on the transfer of assets into the company.

Despite the apparent disadvantages, many people do in fact hold investments inside a company. Following are some of the circumstances in which this might be appropriate:

Personal Tax Deferral

Many business owners accumulate significant profits in their companies. Typically, these profits have been subject to a corporate tax rate of only about 19% for most owner-managed businesses. A personal tax rate of up to 31% (Ontario rate) applies when the owner withdraws these profits from the company as dividends. But this tax liability is deferred as long as the profits are retained in the company. The deferral is a big incentive to invest profits through the corporation rather than drawing them out, paying a large tax bill, and having significantly less to invest personally.

We see many clients maintaining large investment portfolios within their

Continued on Page 4

What's Inside

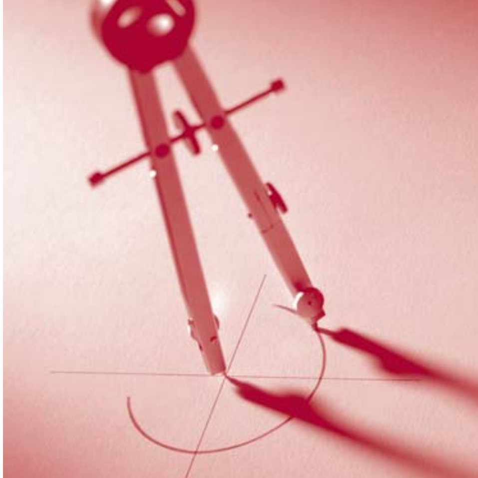
1 *Should You Put Your Investments Into a Corporation?*

2 *Scientific Research and Experimental Development: Are You Missing Out on Tax Credits You Deserve?*

3 *"Freezing" the Value of Your Estate*

Scientific Research and Experimental Development:

Are You Missing Out on Tax Credits You Deserve?



The Canada Revenue Agency's Scientific Research and Experimental Development (SR&ED) program is a tax credit incentive encouraging SR&ED in Canada. The program is used annually by more than 12,000 companies and provides nearly $2 billion per year in tax credits to those businesses. These companies receive a 20-35% investment tax credit for amounts spent on SR&ED during their fiscal tax year. The SR&ED credit parameters are so inclusive that many companies are performing activities that qualify for the credit without even knowing it.

Following are some of the costs and expenses associated with SR&ED, and which might qualify for credits:

- salaries and wages for employees directly engaged in SR&ED
- overhead and other direct costs associated with SR&ED
- materials consumed in SR&ED
- applicable capital expenditures
- payments to contractors and subcontractors

Bottom-line benefits

These credits can add up to significant savings for any business. Eligibility for credit requires actively carrying on a business that undertakes various technical projects meeting the following criteria.

Scientific or technological advancement

This involves the discovery of knowledge that advances the understanding of scientific relations or technologies beyond that which is generally understood and known to professionals working in the field, or which is available through formal training or education. Such work must extend beyond standard practices or routine engineering.

Scientific or technological uncertainty

This involves processes in which the determination of a given objective cannot be obtained through the use of generally-accepted scientific knowledge or experience.

Scientific or technical content

The work must be performed through systematic investigation involving experimentation, analysis and a conclusion, and must be performed by suitably qualified, experienced personnel.

Following are some questions you should consider in determining whether your business might qualify under the SR&ED program:

- Have you changed a process to improve your operations and reduce costs?
- Have you created a new product, built a prototype, or made improvements or added new features to an existing product?
- Have you designed or developed new software?
- Have you incurred costs related to a process, project or prototype that is incomplete because of unresolved technical problems?
- Are you involved in engineering, design, data collection, testing or other developmental work?

Your Collins Barrow advisor can help you answer these questions. If your business qualifies for the SR&ED program, we can assist with claim preparation and submission, financial reporting and the post-submission audit process. The only real risk for any business lies in not acting promptly to take advantage of these credits for qualifying SR&ED.

"Freezing" the Value of Your Estate

Upon the death of a taxpayer, the Canada Revenue Agency requires the taxpayer's estate to treat his or her assets as though they were sold on the date of death for their then-current value (unless they are left to the taxpayer's spouse). Any accrued gains on shares of a family business, an investment portfolio, real estate or other assets must be reported on a final tax return. Half of any capital gains are included in income and subject to tax.

The term "estate freeze" refers to a transaction undertaken to "freeze" the current value of an asset in order to try to minimize this tax liability. This is achieved by replacing an asset that increases in value with an asset that remains fixed in value. The "freeze" effectively avoids any further increase in the amount of capital gain that will be taxed to an estate. Instead, the tax on the future growth of any particular asset will be deferred until the estate beneficiaries, most often the taxpayer's children or grandchildren, dispose of that asset. Thus, estate freezes are particularly appropriate for taxpayers owning substantial business or other assets that are expected to continue to increase in value over time.

The following tax, estate, and retirement planning issues can be addressed as part of an estate freeze:

- Allowing participation in the future growth of a business by a spouse, children or key employees;
- Planning business succession;
- Quantifying life insurance needs at death to meet tax obligations;
- Taking advantage of the $500,000 individual capital gains exemption for family members;
- Income-splitting with lower income family members;
- Reducing estate administration taxes at death;
- Reducing exposure to U.S. estate tax; and
- Creditor-proofing assets.

Consider the following example illustrating a typical estate freeze procedure. Jim owns a company he started many years ago with nominal capital. The company is now worth $500,000 and is expected to continue growing in value. Jim's son works in the company and Jim wants him eventually to inherit it.

With no estate freeze, the value of the corporate shares must be reported on Jim's final date-of-death tax return. The tax to Jim's estate could be substantial. If, for example, the shares are worth $2 million when he dies, the tax could be as high as $464,000 in Ontario ($390,000 in Alberta).

With an estate freeze, however, Jim can "freeze" the value of his shares at their current value of $500,000 by exchanging his existing common shares for equivalent-value preferred shares that will not increase in value. His son can then subscribe for newly-issued common shares at a nominal price. The transaction is completed without any immediate tax consequences. Any subsequent increase in value above the $500,000 level will accrue to his son's new common shares.

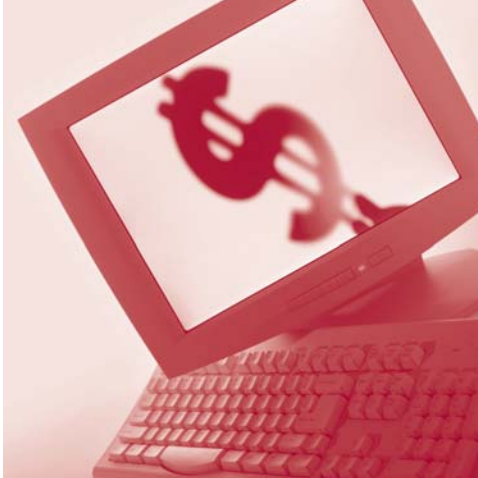
If he wishes, Jim can continue to maintain control of the company even after the estate freeze. His preferred shares might be set up with voting rights. Alternatively, he might opt to freeze only some of his common shares, retaining the others for their voting rights. Similarly, Jim can continue to receive income from the company through dividends on his shares, by redeeming shares, or by drawing a salary if he continues to work.

When Jim dies, his preferred shares will be worth a maximum of $500,000, substantially reducing his estate's tax liability. Indeed, the tax could be eliminated altogether if the gain can be sheltered by the capital gains exemption, which exempts up to $500,000 of eligible gains.

Other considerations in Jim's estate freeze might include the following:

- Ensuring a fair and equitable division of assets in Jim's estate among his other children;
- Minimizing exposure to potential future claims under provincial family law in the event of a marital breakdown;
- Ensuring Jim and his wife will have an adequate income stream through the rest of their lives; and
- Securing Jim's investment in the business in the event of future financial problems.

Your financial position, future goals and family situation will affect whether an estate freeze is an appropriate estate-planning tool for you. Your Collins Barrow advisor will be happy to help you with this determination.



Continued from Page 1

companies for just this reason. A private company in this situation could be described as something akin to a corporate RRSP, where personal taxes are deferred until funds are withdrawn.

Pre-1996 Tax Rates

Prior to 1996, there was a significant imbalance in the tax system. Personal tax rates were as high as 54% while the top corporate tax rate was 45%. At that time, putting investments into a company provided a large tax deferral until the income was distributed to the shareholder. Many personal holding companies were set up in the early 1990s to take advantage of this situation, and continue to exist today.

U.S. Estate Taxes

A personal holding company can reduce exposure to U.S. estate taxes. The estates of high-net-worth Canadians who die owning U.S. assets can face large tax bills and complex paperwork from Uncle Sam. Taxes are levied on the gross value of the estate assets regardless of whether they have increased in value. Several strategies exist to minimize the impact of these taxes. One such strategy is to hold U.S. assets inside a Canadian corporation, as U.S. estate taxes apply only to assets owned by an individual directly. For example, shares of General Electric owned by a Canadian holding company are not considered to be owned by the individual shareholder and are therefore not subject to U.S. estate taxes.

Income-Splitting

Previously, the use of a holding company sometimes provided a means to split investment income between family members in certain circumstances and with careful planning. However, as a result of complex rules enacted by the Canada Revenue Agency, few opportunities now exist to split income in this way.

Those who already own investments inside a holding company likely will want to maintain the status quo. There probably were, and continue to be, good reasons for keeping the investments in the company. Conversely, if you are considering putting investments into a company now, consult with your Collins Barrow advisor to determine whether there are any other investment strategies more appropriate for your circumstances.

Collins Barrow Office Locations:

Banff	Hearst	Sarnia
Bobcaygeon	Kapuskasing	Stratford
Calgary	Kingston	Sturgeon Falls
Cambridge	Leamington	Sudbury
Canmore	Lindsay	Toronto
Carleton Place	London	Vancouver
Chatham	Manotick	Vaughan
Chelmsford	Montreal	Wallaceburg
Drayton Valley	North Bay	Waterloo
Edmonton	Orangeville	Winchester
Elora	Ottawa	Windsor
Exeter	Peterborough	Winnipeg
Fenelon Falls	Red Deer	

Contact Information:

Internet: www.collinsbarrow.com
Email: info@collinsbarrow.com
Careers: careers@collinsbarrow.com

Collins Barrow regularly publishes Tax Alert for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Alert suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.