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New Tax Commentary is Food for Thought

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In this article, I would like to talk about a couple of recent publications that will be of interest to tax and estate planners. The first release has garnered attention in the national financial press, as it may fundamentally alter the conventional wisdom on owner-manager remuneration. The second is a technical article on the “corporate attribution rules” appearing in the latest issue of the Canadian Tax Journal.

Rethinking RRSPs

A longstanding axiom of owner-manager remuneration is pay yourself enough salary to max out on your RRSP contribution. But a release by the CIBC Private Wealth Management group throws this into question. “Rethinking RRSPs for business owners: Why Taking a Salary May Not Make Sense” by Jamie Golombek**[1]**, contends that, to the extent that the business owner needs cash personally, it may be preferable to extract the cash from the corporation in the form of dividends and forego the RRSP contribution.

Increasing RRSP contribution limits in recent years have necessitated increased salary or other “earned income”, necessary to make maximum RRSP contributions. That’s because, subject to the ceiling for the particular year ($22,000 for 2010 and $22,450 for 2011), RRSP contributions are based on 18% of previous year’s earned income (which does not include dividends). The maximum 2001 contribution limit necessitates a salary of $124,722 in 2010 which, in Ontario, would put an individual in the second highest tax bracket, just 3% off the top marginal rate of 46.41%. Meanwhile, dropping corporate small business rates have lowered the “toll charge” for retaining income earnings at the corporate level rather than paying out salaries and bonuses.

Somewhere along the line, the ground rules changed. The report states:

“It is our position that business owners would end up with more money after-tax by funding their personal living requirements with dividends and leaving the excess cash in the company as opposed to paying the salary required to maximize the RRSP contribution.”

To test this hypothesis, a model was built to compare the net after-tax cash amounts to a business owner over a 20-year period, assuming equity, balanced, and fixed income portfolios, all three of which fared better with the dividend strategy.**[2]**

Far be it from me to second guess CIBC – much less Mr. Golombek. It’s just that I wanted to see the numbers with my own eyes. So in my usual “Ontario-centric” manner, I decided to compare the salary that would permit a maximum 2011 RRSP contribution, with a dividend that would generate the same amount of after-tax cash as is available from the salary net of the RRSP contribution – i.e., to provide the individual with the same amount of disposable cash. After several iterations, calculations revealed that the cash retained in the corporation under the “dividend alternative” would be about 20% higher than the cash deployed in the maximum RRSP contribution. With 20% more cash to generate earnings, this intuitively suggests that a long accumulation period would be necessary for the RRSP’s tax deferral features to make up for this difference. Based on a 5% return (on a fully taxable investment), it seems that an accumulation period of close to 30 years must occur in order to make up for the spread. In plain words, the RRSP piggy bank must remain intact for that period of time, before the salary/RRSP alternative would pay off.

Of course, this analysis is just the beginning of the computations. For example, favourable tax treatment of investment income/capital gains militate further in favour of corporate accumulation rather than RRSP investment, where the tax benefits are effectively lost. In the current financial environment, where interest rates are at or near all-time lows, this could be an important factor, since Canadian dividends can often provide a higher yield. Of course, tax-free status on 50% of capital gains will also be available. Personal tax rates on the "back end" should also be considered, although dropping rates may be somewhat illusory, what with the various clawbacks that kick in.**[3]** Eventually, the RRSP piggy bank must be broken, as the RRSP must mature no later than the year in which the annuitant reaches the age of 71, whereas the corporate alternative can provide longer term deferral, especially where estate freezes can be implemented**[4]**. Leaving funds at the corporate level may expose them to creditor claims, although this can be mitigated with holding company structures. On the other hand, federal bankruptcy laws were recently amended to provide that RRSPs and RRIFs are protected from creditors upon bankruptcy, other than contributions made within the final 12 months prior thereto.**[5]**

As the report also points out, in general (i.e., ignoring RRSPs) there is an advantage to paying dividends over salaries in all provinces other than Quebec. The overall tax rate reduction by paying corporate taxes on small business income and distributing the after-tax profits as dividends is 3.1% in Ontario (1% and 1.2% in BC and Alberta, respectively).**[6]**

Corporate Attribution Rules: "Back to back" Transfers

As most readers are aware, the corporate attribution rules can be a significant tax trap in attempting to use a corporate vehicle for income-splitting or estate freezing. Section 74.4 provides for tax penalties in certain situations where an individual has transferred (or loaned) property to a corporation (other than a company maintaining "small business corporation" status) either directly or indirectly. The rules potentially apply where one of the main purposes of the transfer (or loan) is to reduce the income of the transferor and benefit a "designated person"; this includes the transferor's spouse, or a child or other non-arm's length person**[7]** who has not reached the age of 18 in the year. The rules may impose taxable benefits in the form of deemed interest, at the prescribed rate for the particular period, based on the amount of the transfer (or loan). A corporate reorganization can be classified as a transfer. Therefore, the corporate attribution rules can apply both to estate freezes which involve transfers to holding companies, as well as those involving a direct reorganization of the capital of the corporation itself.

An interesting article entitled "Corporate Attribution: The 'Anti-freeze' Rule", by Paul Festeryga appears in the latest issue of the Canadian Tax Journal**[8]**. A focus of the article is on subsection 74.5(6) and its effect on the corporate attribution rules. Those who take a peak at this provision will notice is that it is captioned "Back to back Loans and Transfers" - more on this later.

The first part of the provision**[9]** applies where an individual has transferred or lent property to another person [e.g., his or her corporation] and that property or substituted property is in turn transferred [e.g., by that corporation] to or for the benefit of a "specified person" with respect to the individual - this generally includes corporations where family members who are "designated persons" are significant shareholders. If the rules apply, the individual who made the first transfer is deemed to have made the second transfer**[10]**, thus putting the corporate attribution rules into play. Presumably, the intention (purpose) required for the operation of the corporate attribution rules is to be applied to the individual who made the first transfer – but at the time of the subsequent transfer.

But the "back to back" caption may be a misnomer. As the author points out: there is no requirement that the second transfer be part of a series of transactions. The subject assets could have been transferred years earlier without any thought of a subsequent transfer or without the condition that they be transferred at a later date, and yet the rule could apply.

Thus, the rule could be applicable in a downstream or reverse freeze situation. For example, where assets of a corporation are transferred to a second corporation in return for freeze shares (with the common shares of the second corporation held by family members or a family trust), the

back to back transfer rules could apply if the property transferred in the reverse freeze “emanated” from the individual shareholder of the transferor corporation.**[11]**

The author maintains that the back to back transfer rules will not apply where the second transferee is a small business corporation (basically, a corporation whose assets are devoted to Canadian active business activities)**[12]**. Furthermore, unlike the general corporate attribution rules, there is no requirement that the transferee corporation maintains its small business corporation status – it just has to qualify at the time of the second transfer. Fortunately, small business corporation status will often apply where these types of freezes are implemented.

One of the Technical Interpretations cited in the article**[13]** indicates that, in situations where a controlling shareholder/director of a particular corporation approves a transfer or loan of property by the corporation to another corporation and the property may be considered to come from the transferor corporation’s retained earnings (for example, internally generated cash or investments of the particular corporation), it is the CRA’s view that the back to back rules would not apply for the purposes of the corporate attribution rules. Perhaps one reason for the CRA’s administrative largesse is that it is difficult to apply these rules in the context of a corporation carrying on business.

But in spite of the potential exclusions from the back to back transfer rules, the bottom line is the back to back rules are a factor that should be considered carefully when assessing the applicability of the corporate attribution rules.

My sincere compliments to both authors for their insights.

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[1] Available at www.cibc.com/ca/pdf/jg-rethinking-rrsps-en.pdf.

[2] The model was designed with the assistance of Deloitte & Touche LLP’s Private Company Services Group.

[3] This is discussed in the context of income-splitting. The release points out that income from an RRIF can be split with a spouse or partner once annuitant is 65 years of age or older; however, income-splitting opportunities may also be available for dividends.

[4] For example, restrictions may apply in respect of professional corporations.

[5] This protection only applies to persons who have entered formal bankruptcy proceedings; it will do nothing for those experiencing financial difficulties but who avoid bankruptcy.

[6] In Ontario, the advantages are even greater when Employer Health Tax is factored in. Another advantage of paying dividends is that they avoid CPP and EI premiums (where applicable), usually regarded as disadvantageous by owner-managers.

[7] Or a niece or nephew.

[8] 2010 Volume 58 No. 3, p.675.

[9] I.e., paragraph 74.5(6)(a).

[10] See paragraph 74.5(6)(c).

[11] In Doc. No. 2003-0018915, June 10, 2003, the CRA took the position that, where an individual transferred common shares of “Company C” to “Company B” and two years later, the common shares of “Company C” were “section 86’d” for freeze shares, with a family trust subscribing to common shares of “Company C”, the section 86 reorganization is subject to subsection 74.5(6), so that the deemed transferor (to “Company C”) would be the individual.

[12] On the basis that paragraph 74.5(8)(b) excludes a small business corporation from “specified person” status. Note, however, that paragraph 75.6(6)(a) applies where the property is transferred or lent “directly or indirectly to or for the benefit of a specified person”.

[13] Doc. No. 2002-0147325, January 15, 2003.