FALL 2018

THE Quarterly Dividend

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Your guide to income tax & financial planning

FAST TRACK

The Four "Smarts" You'll Need in Business and in Life

People often wonder if they "have what it takes" to go into business. The answer is always yes, because "you are you". You will be the same person after starting an owner/managed company as you were before. The only change might be is that you will look at things from a different perspective. Once entering busi-

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Tax On Split Income

One of the most controversial tax changes enacted in the 2018 Federal Budget was the government's attack on "income splitting" that had been enjoyed by taxpayers for decades.

The income tax strategy, up until now, has always been for families to arrange their "taxable incomes" in such a way that each of the spouses would be paying roughly the same percentage of their earnings in taxes as would their children who were above eighteen years of age.

This was typically done, in owner/managed companies by having the business pay salaries to each family member in amounts that would accomplish this objective.

Some families extended this concept to include the payment of dividends, but that was usually "reserved" for only the spouses themselves.

The Trudeau government has set its sights on companies with investment income and those who appear to have spouses and children on the payroll in "name only", in other words, where their contributions to the family business are negligible at best.

If it is determined that the amount of salary is not commensurate with the number of hours "put in" the family business by the spouse, the government will impose its "Tax on Split Income" on the spouse's earnings and have the offending income taxed at the highest personal tax rates.

In 2017 the highest tax rates in Ontario, for example, were 42.40%

Starting in 2018 the decision as how much of a salary and dividend (if any) the owner/managed business should allocate to "spouses" and "children" will take on added importance.

It will be important to honestly assess your spouse's and children's contribution to the business to determine whether continuing with the old policies can be justified.

It will be essential to "pay them" what the company would have paid a "stranger" to perform the same work that the spouses had been entrusted to perform.

By utilizing this rule of thumb, owner/managed businesses will be "on side" with the legislation, although they will undoubtedly be paying more taxes than they ever did before.

The only consolation is that these rules and regulations are new and therefore will be analyzed over the months and years ahead to determine where their "sweet spots" might be and how creative owners and their professional advisors can work within the laws to soften the blow.

Compliments of

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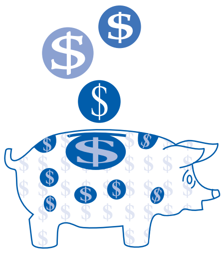


ness you will have to focus your attention on a particular "skill set" which may be very different from what you were using before.

Starting a business requires deciding "what you want to do". Most people decide to pursue something about which they are already familiar. It is the "subject" described in the first of the four "smarts" listed below. It is the foundation upon which you build the other "smarts" you will need as you develop and grow. The others will come in time, all contributing to that change in perspective referred to above.

Here are the four "smarts" you can expect to develop naturally over time:

Knowledge:

(i) a theoretical or practical understanding of a subject

(ii) it is more than information and learning, it includes the contribution of the mind in recognizing data, perceiving relations, elaborating concepts,

Investing in Mortgages

A recent advertisement in the newspaper placed by a Canadian financial institution offered "investors" a return of 3.5% for a five year, non-cashable Guaranteed Investment Certificate and smaller returns on GIC's purchased for shorter periods of time.

With rates such as these, taxable and probably not covering the rate of inflation, it is understandable that many Canadians are seriously considering refinancing their homes, taking out some of the equity they have built up over the years, and investing in mortgages through a private lender.

As long as the paperwork is done correctly, and the investor's loan is secured by registration on title to a particular property, the risk of default should be low.

Here is an example of how investing in mortgage "works".

Step One: Obtain Re-financing

(a) Joe lives in a home that is currently valued at $450000 and is carrying a mortgage of $125000;

(b) Joe is willing to go up to 80% of the equity in his home, allowing him $235000 to invest ($450000 x .80 = $360000 - $125,000) at 2.60% per annum with a 25 year amortization;

(c) the mortgage payments are $1630 monthly.

Step Two: Invest in the Mortgage

(a) Joe finds a private lender willing to pay him 12% per annum on funds borrowed from Joe (interest only):

(b) Joe receives $2350 monthly ($28200 per annum) on the $235000 he invests;

(c) Joe is now $720 ($2350 - 1630) "ahead" each month or $8640 on an annual basis.

Step Three: Understand the Taxes

(a) If Joe makes the investment as an individual, the $8640 is added to his "income from other sources" and taxed at his marginal rate. If this is 30%, he will pay $2720 in taxes on his additional income and have $5920 "left over";

(b) If Joe makes the investment through a corporation, he will pay $1685 in corporate taxes and $622 in personal income taxes for a total of $2307 on his additional income. He'll have $6333 in his pocket at the end of the day.

Deemed Dividends

As the saying goes "nothing lasts forever" and in the world of small business it is not uncommon for a shareholder to "want out" of the business in which he is part owner.

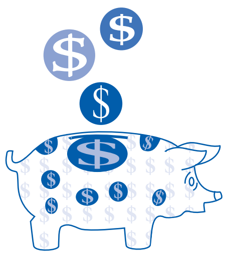
From an income tax perspective, this is termed a "redemption of shares" by the corporation.

Although the shareholder who is leaving would like the transaction to be treated as if he was "selling" his shares back to the company and thereby realizing a capital gain, the Income Tax Act has other ideas.

The Act considers the redemption to be a distribution of the company's assets to the shareholder who is leaving. He is first entitled to "get back" the dollar value of his original investment in the business when he purchased company shares (called "paid up capital").

After that, any additional money paid by the company will be termed a "deemed dividend" to the departing shareholder. By so doing, the shareholder is precluded from claiming capital gains treatment on the transaction and take advantage of the Lifetime Capital Gains Exemption if it were available to him.

Here is an example: Huey, Luey and Dewey were equal shareholders in Company A from



formulating principles, making evaluations;

Understanding

(i) the ability to think; intelligence; the power of abstract thought; to infer from information received;

Discernment

(i) the capacity of understanding hidden truths, especially of character or situations, recognize something as separate, distinct; insight;

Wisdom

(i) combine experience and knowledge and judiciously apply them in action; behavior determined by or showing in harmony with experience and knowledge

(ii) become aware after the event or circumstances to understand and assess their implications going forward

Here is one way they can be attained:

(a) each of us has a certain range of raw knowledge about something in our lives. We should strive to harness this knowledge in some way. Some

the very beginning of the business. Each purchased 1000 common shares for $1000.

Dewey would like to leave the company and relinquish his shares. The Company will pay him $500000 for his shares and then cancel them. What are the income tax consequences?

(a) calculation of Dewey's "deemed dividend"

	$
Amount paid on redemption of shares	500000
Less: Paid up capital	1000
Deemed dividend	499000

This dividend will attract income tax of $190334 in Ontario.

(b) calculation of capital gain

Amount paid on redemption	1000
Less: Adjusted cost base of shares	1000
Capital gain	NIL

(c) other

The company will now have two shareholders, each owning 50% of the company.

If Dewey could somehow persuade Huey and Luey to purchase some or all of the shares personally as opposed to the corporation buying them back, he could then realize a capital gain for at least some of the transaction. In fact, if the corporation were to buy the shares, he would only realize $309666 after taxes. Perhaps they could pay him this sum of money for his shares. He would claim the capital gains exemption and have no income tax to pay on the transaction.

Even if it was ultimately financed through the company as shareholder loans, the business would only need to come up with $309666 rather than the $500000.

Huey and Luey would each still end up owning 50% of the company.

Partnership Income

A partnership is a business relationship entered into by two or more individuals with a view towards making a profit. What makes this form of business different from an incorporated company is:

(a) the entire period's income or loss is allocated to the individual partners according to their respective levels of participation, typically set out in a partnership agreement between the parties;

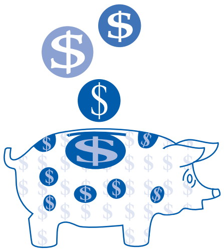
(b) each individual partner must include in his personal income for the year his share of the income or (loss) of the partnership income whether he withdrew the funds from the partnership or not;

(c) the income that flows through the partnership to the individual partners will retain the same characteristics that it had in the partnership itself. In other words, interest income earned by the partnership, will be allocated among the individual partners as interest income according to their specific percentages of ownership; and

(d) each partner is "on the hook" for each other's liabilities whether they were the result of the partnership's operations or not.

Here is an example of a partnership between Jack and Jill. They have agreed: (i) that each partner will contribute his pro-rata share of $2000 to the partnership annually with these contributions to be retained in the partnership year over year, (ii) Jack's participation is 70% and Jill's is 30%, and (iii) each partner will be allowed to withdraw $1000 per month from the partnership.

The determination of their incomes for income tax purposes and the balances in their respective capital accounts for accounting purposes is as follows:



choose to apply it formally by perhaps applying it in a business setting, others are more discreet and low key. Both are equally rewarding;

(b) while knowledge pertains to expertise in a certain area, understanding expands the horizon and allows you to apply it with skilfulness and competence through reasoning and comprehension;

(c) discernment expands the first two factors and allows the application of good judgment and instinct to the mix, thereby enabling you to come up with your own special brand of

(d) wisdom regarding the matter at hand.

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1) partnership income (for income tax purposes)

	Total	Jack	Jill
	$	$	$
Interest income (net)	5000	3500	1500
business income (net)	45000	31500	13500
	50000	35000	15000

Jack will "pick up" $3500 interest income and $31500 business income on his personal income tax return for the year. Jill will declare $1500 and $13500 on her income tax return.

2) analysis of their capital accounts (for accounting purposes)

	Total $	Jack $	Jill $
Balance, beginning of year	2000	1400	600
Capital contributions	2000	1400	600
	4000	2800	1200
Income for the year	50000	35000	15000
	54000	37800	16200
Drawings during the year	24000	12000	12000
Balance, end of the year	30000	25800	4200

Deferral of Capital Gains

Taxpayers who realize a capital gain from the disposition of qualified small business shares of a company (termed the "old" corporation) can defer the taxes owing on the transaction by reinvesting the funds in another qualified small business corporation (termed the "new" corporation).

By doing so, the cost base of the "new" corporation will be adjusted by the amount of the capital gain that would have been declared in regard to the "old" corporation, thus deferring the capital gain until such time as the shares of the "new" corporation are disposed of (unless this deferral is exercised a second time).

Here is how it works:

Erin makes a qualifying disposition of shares of Corporation A with an Adjusted Cost Base of $1 million for proceeds of disposition of $1.5 million. She then purchases replacement shares in Corporation B for $1 million.

There are three components to this transaction: (i) the total cost of all replacement eligible small business shares which in this case are the shares of Corporation B or $1 million; (ii) the qualifying portion of the proceeds of disposition in the sale of Corporation A shares, in this case $1.5 million ; and (iii) the capital gain that arose from the sale of Corporation A's shares, $500000.

The permitted deferral is determined by dividing (i) by (ii) and multiplying the quotient by (iii). Here the figures work out to be $1000000/$1500000 = .6666 multiplied by $500000 or $333333.

The capital gain that Erin will show on her personal income tax return will consist of the capital gain as otherwise calculated or $500000 minus the permitted deferral of $333333 or $166667.

The adjusted cost base of Erin's Corporation B shares will be her actual cost of $1 million less her permitted deferral of $333333 or $666667.

Please note that Erin will not be able to defer the capital gain if, after acquiring Corporation B shares she does not deal with it "at arm's length".