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COMMENT

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CORPORATE ATTRIBUTION

Income splitting involves spreading income out over more than one taxpayer so that the income may attract a lower rate of tax. Income splitting opportunities, however, are curtailed by many well-known attribution rules within the Income Tax Act (the "Act"). For instance, most individuals know that they cannot simply give away investment property to their spouse or minor child without some level of income attribution.

There are, however, some less widely understood attribution rules. For example, there is an income attribution rule designed to prevent income splitting using a private corporation that is not a small business corporation. A small business corporation is generally defined as a company where all or substantially all (i.e., 90 per cent or more, according to the Canada Revenue Agency (CRA)) of the fair market value of its assets is used to carry on an active business primarily (i.e., 50 per cent or more, according to the CRA) in Canada.

The corporate attribution rules apply where

- an individual has transferred property to a corporation, either by way of loan or as subscription proceeds; and
- one of the main purposes of the transaction was to reduce the individual's income and to benefit a designated person.

A "designated person" is defined by the Act as the individual's spouse or common-law partner, or a minor who does not deal at arm's length with the transferor, including the individual's niece or nephew.

The concept of "purpose" can be very elusive. The CRA generally uses a results test to determine purpose. The presumption is that if a transaction results in the conveyance of a benefit to another, the purpose of the transaction was to create a benefit.

Attribution will apply in all future years where

- the definition of designated person continues to apply;
- the designated person holds at least 10 per cent of the issued shares of any class;
- the transferor is a resident of Canada; and
- the company is not a small business corporation.

Rather than simply attribute the actual income amount that was "split" with the designated person, the corporate attribution rules deem the transferor to have received interest, calculated at the current prescribed interest rate, on the amount the

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individual transferred to the corporation. The interest benefit is reduced by any interest and 5/4 of any dividends actually paid by the corporation to the transferor. The interest benefit is also reduced by any dividends paid to designated persons who are minors, since in these circumstances the "kiddie tax" rules would apply. It is also important to note that the corporation is not permitted a deduction for any deemed interest income attributed to the transferor.

The corporate attribution rules are some of the harshest of the attribution rules because the deemed benefit conferred on the transferor may have no relationship to the actual amount of income being split. In fact, a deemed benefit can arise even where no income is paid to the designated person. It is therefore important to keep these rules in mind when attempting to split income with family members.

I/R 2500.13

CRITICAL ILLNESS INSURANCE AND THE BUY-SELL AGREEMENT

Critical illness insurance and a buy-sell agreement are both useful tools that can be employed to protect a business owner's financial well-being. Critical illness insurance provides a lump sum of cash upon the diagnosis of a listed medical condition. A buy-sell agreement between business co-owners spells out when a business owner's shares will be transferred, along with the price and terms of the transaction.

The growing popularity of critical illness insurance has resulted in the development and consideration of many new applications for the product. One such consideration is whether a buy-sell agreement should be tied to and funded with critical illness insurance.

One advantage of such a strategy is that each shareholder knows that there is a market for his or her shares and that funding is in place to complete the sale if a critical illness occurs. Knowing that the shares will be liquefied upon the occurrence of a critical illness, an individual can better plan his or her financial affairs.

One of the biggest drawbacks to automatically triggering the buy-sell agreement upon the occurrence of a critical illness is that the individual may not want to sell. Critical illness pays a benefit upon the diagnosis of a listed condition. However, the condition might not be immediately disabling or life threatening, or of a long duration. In that case, the individual might want to continue to participate in the business. Even though the shareholders' agreement could contemplate such a situation and allow the shareholder to buy back into the company, the disposition will have triggered tax consequences and the shareholder might not have sufficient resources to fund the repurchase (especially if he or she is also facing substantial medical expenses).

If critical illness insurance is included in the shareholders' agreement, consideration should be given to designing the buy-sell agreement so that the critically ill shareholder has the option of whether to sell. This option allows the shareholder to decide whether to trigger the sale. If the shareholder decides to sell, the insurance funds will be available to provide the required funding. To the extent that the critical illness insurance coverage is insufficient to fully fund the buy-sell agreement, the agreement should provide alternate terms that will allow the continuing shareholders to complete the agreement. If, however, the critically ill shareholder decides not to complete the buy-sell, the insurance funds could be used as key person coverage to help finance the business operations during the shareholder's recovery period.

It might also be appropriate to have critical illness insurance provide an additional layer of funding on the buyout

of a permanently disabled shareholder. In other words, where a shareholder has become permanently disabled in a situation where a critical illness benefit is also payable, the proceeds can provide funding over and above that provided under disability buyout policies (if any). Careful drafting of the shareholder agreement is necessary to ensure proper co-ordination of these two triggering events. For example, critical illness proceeds are typically paid 30 days after diagnosis, while a determination of permanent disability and the payment of disability benefits may not occur for a year or more.

The design of a shareholders' agreement should take into account a list of triggering events that stipulates when a buy-sell takes place. The list of events could also be broken down into obligatory and optional purchases/sales, depending on the objectives of the shareholders.

While these comments apply to shareholders of a closely held corporation, the same considerations apply to members of a partnership.

I/R 1450.06

THE THEORY OF INTEGRATION

A foundation of Canadian tax policy is equality between similar taxpayers. The theory of integration works to ensure that an individual is indifferent to earning income directly or through an incorporated company. This policy is implemented through a framework of income tax provisions and tax rates.

Consider the following example:

Business income: $200,000
Personal tax rate: 45%
Business* tax rate: 20%
Effective** dividend tax rate: 30%

* this is the approximate tax rate on small business income
** recognizing the dividend gross-up and tax credit mechanism

	Income earned directly ($)	**Income earned through a company ($)**
Business income	200,000	200,000
Corporate taxes		(40,000)
Personal taxes on income	(90,000)	
Corporation's net cash position		160,000
Dividend payment		(160,000)
Dividend received		160,000
Personal taxes on dividend		(48,000)
Individual's net cash position	110,000	112,000

Using these assumptions, the net cash position is approximately the same for an individual who earns income directly compared with earning it through a corporation. The slight difference is caused by the assumptions used and, accordingly, the results will shift marginally based on the tax rates used. The above analysis can be refined by matching it more closely to a taxpayer's own fact situation (such as province of residence and marginal tax bracket).

The above example assumes that the taxpayer pays out all of the income from the corporation in dividend form, perhaps because the cash was required for personal expenses. (Remember that income might also be paid out to an owner-manager in the form of salary or bonus – the choice between salary and dividends is an important one, but is beyond the scope of this article.) If, on the other hand, a taxpayer is interested in accumulating capital or preserving as much cash as possible in order to grow the business, the use of a corporation can create a valuable tax deferral opportunity.

In this scenario, the corporation had to pay $40,000 in tax on the income, leaving it with $160,000 to reinvest. If the income was earned directly, however, the individual retains only $110,000. This means that earning the income through a corporation leaves an extra $50,000 available for expansion or accumulation if the funds are retained inside the corporation and not flowed out immediately to the shareholder. This is referred to as a tax deferral, because when those funds are eventually paid out to the individual, the total tax paid on those earnings (by the corporation and the individual) will approximately equal the $90,000 in tax paid by the individual if income is earned directly.

It is important to note that the Income Tax Act contains special rules to eliminate this deferral for investment income (such as portfolio dividends, rents, interest and taxable capital gains) earned through certain corporations. These rules impose an additional tax on investment income earned at the corporate level, to bring the corporation's retained income to approximately that of an individual who earned the income directly (i.e., another integration mechanism). That additional tax is eventually refunded when the corporation pays dividends out to the individual shareholders. The net result is consistent with the integration example illustrated earlier in this article. These rules remove tax deferral opportunities that would otherwise exist by setting up a corporation to hold investment properties.

The integration mechanisms can be complex, but their ultimate goal is to ensure that taxpayers who earn similar amounts and types of income are taxed in a similar manner.

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