

TODAY'S ISSUES



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HOLDING COMPANIES FOR WEALTH TRANSFERS

My article in the November/December issue of the MoneySaver discussed how you can put your will in motion before you die. Well, here's a good example.

In late 1999, Bill and Sue were well into retirement. Sue was in excellent health and Bill was in average health. They had total assets of about \$2,500,000. With Bill's company pension, their RRSP's and income from investments, their financial plan showed that they are easily able to meet expenses for the rest of their lives and in fact have surplus assets.

Given their strong financial position, they were able to consider a plan to start giving away assets to their family now. This would also reduce future income taxes. In 1999 Bill transferred \$685,000 of his investment portfolio to a holding company (Holdco). Sue kept her portfolio in her own name. Bill made the transfer on a tax-free basis using a special provision of the Income Tax Act (Section 85) and received \$365,000 in special Holdco shares and \$320,000 in a company note. Because Bill transferred his investments to Holdco on a tax-free basis, the Holdco shares he got back as consideration had no cost for tax purposes. To complete the planning, common shares of Holdco were purchased by their two sons (Harry and Hank) for a dollar each. Therefore, Harry and Hank will enjoy all future growth in the value of Holdco investments.

Now let's move the snapshot forward to 2005. Holdco invested well and original investments of \$685,000 have now moved to \$1,025,000. That's an average annual rate of return of about 7% but in fact the return was much higher in the later years. Losses in the technology meltdown in 2002 brought the average return down.

Since incorporation, Holdco has realized capital gains of just over \$300,000 on its investments. Our tax laws allow a private company to pay out to shareholders half of realized gains tax free (through what is known as a capital dividend account) or in this case \$150,000. Therefore, \$150,000 of Bill's shares were redeemed in late 2005 by electing to use the tax-free capital dividend account and eliminate all tax on the redemption. After these shares were redeemed, \$215,000 of Holdco special shares still remained outstanding with full exposure to capital gains. How can Bill redeem those shares tax efficiently now to avoid tax at death? There is a solution for that too.

Investment income and capital gains earned by private companies generate refundable tax. In 2005, Holdco had about \$80,000 of the refundable tax available. The Income Tax Act provides that a company will receive a \$1 tax refund for every \$3 of taxable dividends paid. Therefore, if the remaining \$215,000 in Holdco shares are redeemed (creating a deemed dividend for tax purposes),

the company will receive a tax refund of about \$72,000. One must also remember that Bill must pay personal tax of about \$64,000 on the redeemed shares.

The tax refund of \$72,000 to Holdco is greater than the personal tax of \$64,000 that Bill must pay, so there is a net tax advantage to the share redemption. In order to get funds to Bill to pay his personal tax, the company will simply pay down part of the original \$320,000 owing to Bill. When Bill gets the \$685,000 on the two share redemptions, he will lend the money back to Holdco so it can repay the margin account taken out to provide funds to redeem the shares in the first place.

So what have we accomplished? The company owes Bill over \$600,000 and he has eliminated his investment in Holdco shares. Since his two boys own all of the Holdco common shares, they will enjoy all future growth in Holdco investments. The boys have about \$400,000 of value in the common shares. Not bad!

When the idea of the share redemption was discussed just before Christmas in 2005, Bill and Sue were also wondering if they could do something for their grandchildren. They are all in their late twenties and could all use some financial help. Since the company owes Bill about \$600,000, Bill and Sue decided to pay back \$100,000 to themselves and give each of their five grandchildren \$20,000 for Christmas - tax-free. What a surprise the grandchildren got.

When Holdco was set up Bill and Sue were long past retirement age. Today they are both into their late eighties and want to make their lives even less complicated. Bill is not in particularly good health. They are still well off because Sue's portfolio has done extremely well and pension income is still coming in. They really don't want the trouble of looking after Holdco anymore so Bill has decided to give his \$600,000 Holdco note to the two boys. What a great Christmas present!

So action taken back in 1999, just six years earlier, has removed over \$1,000,000 from Bill and Sue's estate and eliminated all related taxes on capital gains and probate fees. Needless to say, Bill and Sue are grateful that they chose to use Holdco to move assets to the next generation in a tax effective way. And they get to see their children and grandchildren reap the benefits of their generosity. Why would they give up that pleasure by delaying this estate distribution until after death? Who knows, but many people do.

This actually happened. My client gave me permission to publish the facts on a no names basis. When the grandchildren opened their cards at Christmas, all of them thought that Grandma had slipped a couple of decimals. The usual Christmas present with the card was \$200. She really did mean it! *This Today's Issue first appeared in the MoneySaver magazine.*

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