Manulife

Tax, Retirement & Estate Planning Services

INVESTMENT INSIGHT

Investments owned by private corporations – Some considerations

Many corporations are looking for ways to invest their cash or to replace current investments. Manulife Investments Guaranteed Interest Contracts (GICs) and Manulife segregated fund contracts may be attractive vehicles for this investment and in fact, the corporation may even consider the Manulife segregated fund leverage program.

Note that the comments contained in this article generally apply to all investments held inside a corporation, unless otherwise indicated, whether Manulife segregated fund contracts, Manulife Investments GICs or other guaranteed interest products, mutual funds, stocks, bonds or the cash value of a life insurance policy. They are collectively referred to as "investments" in this article.

Due to the various personal and corporate tax rates on investment income, it is not generally advantageous to transfer additional investments to an existing corporation or to establish a new investment holding corporation, unless there are persuasive non-tax reasons for doing this. (For example, an investment holding corporation is often an important part of implementing an estate plan. They may also be used to reduce other estate costs, such as probate fees or U.S. estate tax.)

That being said, there are often situations where the funds are already in a corporation – either in an operating company or in an investment holding company. The tax cost of withdrawing those funds from the company may be prohibitive and as such, the corporation itself is looking to purchase investment assets.

Products like Manulife Investments GICs, Manulife segregated fund contracts or other investments would be considered passive investments and, as such, any income earned on these investments would be subject to the high rate of tax.

This article is designed to highlight some of the considerations that need to be taken into account when a corporation owns a Manulife Investments GIC, a Manulife segregated fund contract or other investment. It addresses issues applicable to both operating companies and holding companies. **It is highly technical and should generally be used in consultation with the client's professional advisors and is not a substitute for advice from the client's accountant or lawyer.**

1 Taxation of Corporate Income – Investment income vs. Business income

Active business income up to an annual limit is eligible for the preferential small business tax rate. The rate for the first $500,000[1] (or lower in some jurisdictions) is approximately 15 per cent depending on the province. Active business income in excess of the threshold is taxed at a higher rate (approximately 27 per cent depending on the province).

Investment income, or passive income, earned by a corporation would be taxed at approximately 51 per cent (this varies by province and includes the 30.67 per cent of federal refundable tax on corporate investment income).

Products like Manulife Investments GICs, Manulife segregated fund contracts or other investments would be considered passive investments and, as such, any income earned on these investments would be subject to the high rate of tax. Any refundable tax paid on the investment income is returned to the corporation when it pays out taxable dividends to a shareholder.

2 Impact on the Shareholder's Ability to Claim the Capital Gains Exemption

Shares of a corporation that is a Qualified Small Business Corporation (QSBC) may qualify for the $800,000[2] lifetime capital gains exemption. In order for the shares to qualify as QSBC shares, there are several complex tests that must be met with respect to the type of assets owned by the corporation and the length of the period during which the shares are held.

The shares must be shares of a small business corporation. A small business corporation is a Canadian Controlled Private Corporation (CCPC) in which all or substantially all (i.e. 90 per cent or more) of the assets, on a fair market value basis, are used principally in an active business, carried on primarily (i.e. 50 per cent or more) in Canada by the corporation or a related corporation. Alternatively, the assets meeting the "all or substantially all" test may be shares or debt in another small business corporation which is controlled

[1] The small business threshold is $450,000 for Manitoba and $350,000 for Nova Scotia. All other provinces and territories small business threshold is $500,000 which is equivalent to the federal amount.
[2] For dispositions of qualified property after 2013, the lifetime capital gains exemption limit is increased to $800,000 (from $750,000) and is indexed to inflation for years after 2014.

by the CCPC or of which the CCPC owns at least 10 per cent of the voting shares and value of the small business corporation.

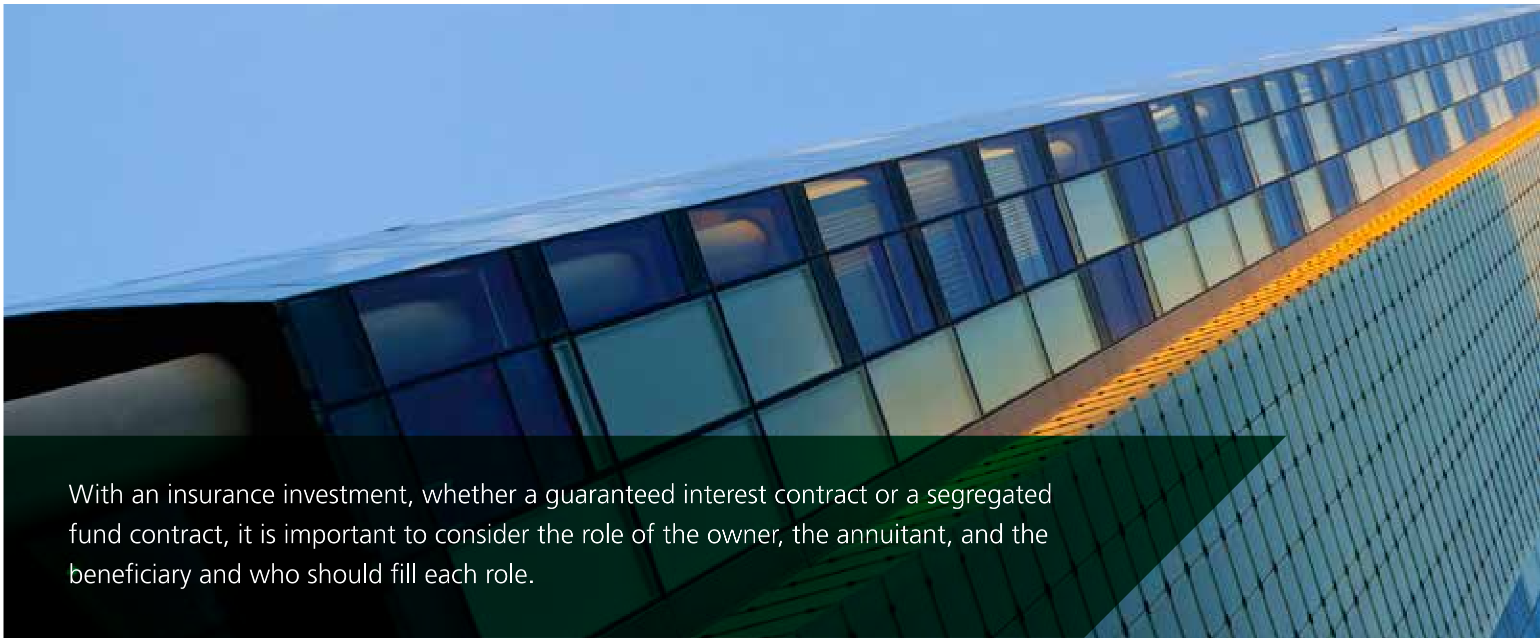
The first test that must be met in order to qualify as QSBC shares is that at the time of disposition at least 90 per cent of the fair market value of the corporation's assets must be used in an active business carried on in Canada, or as an investment in other corporations that are themselves small business corporations.

The second test is a holding period test. To meet this test, the shares must be owned by the shareholder (or related persons) for two years, and during this period, at least 50 per cent of the fair market value of the corporation's assets must have been used in an active business. These tests become very complicated where holding companies are involved.

A corporate owned investment may impact whether or not shares held in a corporation qualify as shares of a QSBC. The QSBC share test is based on how a corporation's assets are used. An investment would be considered to be a passive asset, not used in carrying on an active business by the corporation. In a leverage situation, the debt from the bank borrowing would not impact the QSBC test.

Accordingly, at the time of disposition or crystallization, when the sum of the fair market value of the investments and other passive assets exceeds 10 per cent of the fair market value of all the corporation's assets, the corporation would cease to be a small business corporation and its shares would not meet the conditions to be shares in a QSBC. For the two years immediately preceding disposition, when the sum of the fair market value of the investments and other passive assets exceeds 50 per cent of the fair market value of all the corporation's assets, the corporation would cease to be a small business corporation and its shares would not meet the conditions to be shares in a QSBC. A shareholder disposing of shares that do not qualify as shares of a QSBC would not be entitled to claim the lifetime capital gains exemption.

Consideration must be given to keeping a running total of passive assets in comparison to the value of the company. It is possible that if this does become an issue (i.e. the investments are approaching 10 per cent of the value of the assets), planning can be undertaken to remove tainted assets (purification transactions) in order to ensure the shares qualify as shares of a QSBC. Consideration should also be given to setting up the investment assets in a separate holding company if this is a concern from the start. However, if the assets of the holding company include the shares of the operating company, another reorganization would need to be done as the total assets of the holding company are considered in determining whether those shares are QSBC shares.



3 Impact on the Small Business Deduction

The small business deduction is available to corporations that are CCPCs throughout the year, and entitles them to a tax reduction on their business income up to the threshold of $500,000 of active business income carried on in Canada (the threshold is lower in some jurisdictions).[3] That is, their first $500,000 of active business income is taxed at a lower rate than that of the remaining active business income. Note that the small business deduction is shared among an associated group of companies. A discussion of when corporations are associated is beyond the scope of this article.

Active business income generally includes all business income, except income from a specified investment business or personal services business and includes an adventure or concern in the nature of trade. A specified investment business generates income from property including interest, dividends, rent from real property (land and building) or royalties and employs less than six full-time employees. A personal services business is basically an incorporated shareholder.

The small business deduction will begin to be reduced where the corporation's taxable paid-up capital employed in Canada, on an associated basis, for the immediately preceding year exceeds $10 million and will be fully eliminated where the corporation's taxable capital exceeds $15 million. In general, the small business deduction will be available to many sizable corporations (i.e. those with taxable capital under $10 million) carrying on an active business.

The impact of a corporate owned investment on the corporation's taxable paid-up capital is discussed later in this article under the heading "Impact on Taxable Capital". The loss of entitlement to the small business deduction will only become an issue if the corporate owned investment causes the corporation's capital to be in excess of $10 million.

4 Impact on Taxable Capital

A corporation's taxable capital is essentially the aggregate of the corporation's debt and equity less an investment allowance. The investment allowance includes items such as shares in another corporation, long term loans to other corporations, bonds and long term debt in financial institutions. Canada Revenue Agency (CRA) has indicated that an investment in a mutual fund trust will not qualify for the investment allowance. Although not specifically addressed, a segregated fund contract would also be excluded from the investment allowance.

In a leverage situation, the additional debt created when the corporation borrows will increase the taxable capital. However, the interest paid on the debt should be deductible (see "Interest Deductibility") and as such will decrease the retained earnings and reduce the taxable capital.

[3] The small business threshold is $450,000 for Manitoba and $350,000 for Nova Scotia. All other provinces and territories small business threshold is $500,000 which is equivalent to the federal amount.

5 Impact on the Financial Statements of a Corporation

The corporate investment would initially be reflected on the balance sheet of a company at the cost of the transaction (its book value). Each year, the taxable income allocated to the corporation would initially be included in income and would increase the book value. This will also affect the retained earnings (or deficit) of a company.

If an investment is purchased through a leverage program, the bank loan will be shown as a liability on the company's balance sheet. Assuming the interest is deductible, it will be shown as an expense on the income statement and will correspondingly reduce the retained earnings.

Disclosure in the notes to the financial statements may indicate that the investment has been pledged as security for the bank loan.

Some adjustments may be required as Manulife segregated fund contracts allocate income on a calendar year basis. The T3 reflects the following income: interest, dividends and foreign income realized by the fund, capital gains/losses realized from fund transactions and capital gains/losses realized by the corporation on its trades (i.e., redemptions, fund switches). Therefore, if the corporation has a year-end other than December 31 and it realized any capital gains/losses on its trades, it will need to add these amounts into their financial statements and in the next fiscal period deduct it from the income reported on the T3. Income allocations on the T3 are included in the fiscal year that includes December 31. Adjustments may also be required for other investments such as mutual funds and guaranteed interest products.

6 Insurance Investments – Account set-up and impact on potential creditor protection

With an insurance investment, whether a guaranteed interest contract or a segregated fund contract, it is important to consider the role of the owner, the annuitant, and the beneficiary and who should fill each role.

The owner is, of course, the person or entity who has control over the contract and can manage it as they want (deposit funds, withdraw funds, switch funds, etc) in accordance with the contract provisions and subject to any title restrictions such as a collateral assignment. The owner is also the person responsible for reporting any taxable income on the contract. Obviously, in this case, the owner is the corporation.

The annuitant is simply the measuring life for the contract. This means, that on the death of the annuitant, the contract is terminated and the proceeds are paid to the beneficiary(ies). A Manulife Investments GIC or Manulife segregated fund contract may also allow the policy owner to name a successor annuitant or Joint Life[4]. In the event of the annuitant's death, the successor annuitant or Joint Life steps in as the measuring life. This prevents the termination of the contract on the first death. Generally, in a corporate situation, a successor annuitant or Joint Life would be named, as the corporation does not want to terminate the contract on the death of the annuitant. The corporation needs to consider who the annuitant should be – should it be one of the shareholders or should it be an employee? Note that if it is a leverage program, the individual guaranteeing the corporate loan will also need to be the annuitant.

The beneficiary of an insurance investment contract is the party who receives the funds on the death of the annuitant (or on the later of the death of the annuitant and successor annuitant or Joint Life, if applicable). In all cases, the beneficiary should be the corporation so that the funds are retained in the corporation. In some cases, in an attempt to obtain creditor protection, the company shareholder's spouse or child is named as the beneficiary of the contract. It's important to realize then, that on the death of the annuitant, a corporate asset is being given to a related party. In this type of situation, there will probably be a shareholder benefit under section 15 of the Income Tax Act (ITA) for the value of the amount paid out. In addition, since a corporate asset has essentially been written off, the write off will probably not be available under section 9 of the ITA as the expense was not incurred for the purpose of producing income from business or property.

[4] The Joint Life Option is a guaranteed income stream based on the lives of both the annuitant and the Joint Life. The Joint Life must be the spouse or common-law partner (as defined by the *Income Tax Act (Canada)*) of the annuitant at the time of choosing the Joint Life Option. Only one person can be named as the Joint Life and may not be changed. With the Joint Life Option the contract will not terminate until the later of the death of the annuitant and the Joint Life.

One of the advantages of an insurance investment contract such as a Manulife Investments GIC or Manulife segregated fund contract is the potential creditor protection available during the lifetime of the owner when the beneficiary is of the "family class". In provinces other than Quebec, a family class beneficiary is the spouse, parent, child or grandchild of the annuitant. In Quebec, a family class beneficiary is any of the spouse, descendants and ascendants of the owner. This means that the creditors of the owner may not be able to gain access to the contract if a beneficiary of the "family class" is chosen. However, as indicated above, the beneficiary of a corporate owned insurance investment contract should be the corporation. Obviously, this is not in the family class, and as such, the insurance investment contract is exposed to the creditors of the corporation.

7 Segregated Fund contracts – The impact on the capital dividend account

The definition of "capital dividend" in subsection 89(1) of the ITA allows for an addition to the capital dividend account (CDA) of a private corporation for the non-taxable portion of a capital gain of the corporation. A capital dividend may be paid to a shareholder of such a corporation free of tax.

Subsection 138.1(3) of the ITA states that a capital gain or loss of the segregated fund trust is deemed to be a capital gain or loss of the owner. This means that the entire capital gain or loss is allocated to the owner. As such, a corporate owner (that is, a private corporation) can add the non-taxable portion of the allocated capital gain to the CDA.

Also, the non-taxable portion of any capital gains or losses realized by the corporate investor on its trades of the segregated fund contract can be added to the CDA.

For more information, please contact your advisor or visit manulife.ca/investments

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