

Cashing-out the corporation

*Tax-informed methods for
Accumulating, Accessing and Extracting
Liquid Retained Earnings*

some of the scenarios facing business people looking ahead

- I know I need cash to cover taxes and obligations. I don't want to tie it all up in the interim.
- I want to leave my business to one child who works with me. How do I ensure fair treatment of my other child(ren)?
- I need/want to provide an income to a loved one. I need to set aside capital for that. How much is enough?
- I want to secure both a value and buyer for my business. What should I do?
- I'd like to leave something to my church, favourite cause, school, community, etc. but I want to leave something to my children/grandchildren too. I don't have the kind of money to do both.
- I want my heirs to have my possessions, not the garage sale price/proceeds my estate will get for them.

it's all about options

- pay for everything a dollar on the dollar
- pay for everything by borrowing the money @ a dollar + % for each dollar
- pay for everything using discounted dollars @ pennies on the dollar

Addressing cash flow and requirements

- Use corporate dollars to fund obligations
 - fewer gross earnings needed for net income expenses
 - greatly improves/augments liquidity within corporation and
 - properly planned will do the same for heirs/shareholders

Cashing-out the corporation

- *Client parameters*
- *Insurance need*
- *Tax issues*
- *Exempt insurance*
- *Case application*

Client parameters

Beneficiary/ies

Business stage

Time horizon

Maintenance

Risk profile

Cashing-out the corporation

Insurance need

Cashing-out the corporation

Tax issues

Shareholder taxation

- Income taxed in corporation
- Gross-up and dividend credit to shareholder
- Top MTR (Ont. '04-05) 44.79%
 - Dividend tax credit: 5.13%
 - Actual dividend \$100.00
 - 1.25 div gross-up 25.00
 - Taxable dividend 125.00
 - Federal div tax credit 16.67
 - Prov'l div tax credit 6.41
- MTR on dividends: 31.34%

Tax issues

Corporate insurance

- Cost of insurance
 - Corporate after-tax dollars
 - SH's after-dividend dollars
- Premiums not tax-deductible
 - Exceptions
- Is same benefit attainable?
 - Personal insurance
 - Corporate insurance
- Mixing interests?
 - Corp-payor, SH owner
 - Corp-owner, SH beneficiary
 - Shareholder benefit s.15(1)
 - Prefer dividend tax treatment

Tax issues

CCPC: Active v. non-active income

- Ontario 2005 - CCPC
- Active business income
 - < \$275K 17.12%
 - < \$400K 26.12%
 - \$1129K + no SBD
- Non-active income: 44.79%
 - Basic federal tax 28.00%
 - 38% - 10% abatement
 - Surtax (4% of basic) 1.12%

- Inv. refundable tax 6.67%
- Provincial tax - ON9.00%

Tax issues

RDTOH limbo

- “Refundable dividend tax on hand” on non-active income
 - Notional tax account
 - Inert funds held by CRA
- Deposit calculation: **26.67%**
 - Refundable tax 6.67%
 - 20% of basic fed tax 20.00%
 - Non-refundable part 18.12%
(44.79% - 26.67%)
- Retrieving RDTOH
 - Declares taxable dividends
 - 3-for-1 refund to corporation

Tax issues

Capital Dividend Account credit

- Integration theory
- CDA = After-tax surpluses
 - Net after-tax cap. gains/losses
 - Intra-corporate CDA transfers
 - Ins. proceeds net of own ACB
 - Using related corporation?
- Mechanics
 - Taxable dividend
 - Elect to come from CDA
 - Dividend when credit exists
 - Dividend when cash poor

Tax issues

Net cash flows

Cashing-out the corporation

The Beauty of Liquidity

- fast and easy settlement
- no distress sale prices on your assets
- easy to parcel out/divide
- can avoid a “middleman” saving time and dollars
- takes away the pressure

Accumulating Excess Surplus

- Cash (flow) not needed for daily operations
- avoid personal taxable income
- want: safety, accessibility, flexibility, security

The challenge with building retained earnings

- All corporate savings and investment income taxed at maximum rate regardless of status of company or its tax bracket on earned/operating

income

- no effective way of getting retained earnings out of corporation to shareholders on tax-free basis

The challenge with building retained earnings

- Desire to optimize rate of return but retain access to cash
- most monies in cash (chequing, short term paper and short term GICs)
- lower rates of return traded against easy access to lump sums of retained earnings

Laddering

- Optimizing returns
- minimizing risk

- How much of your retained earnings are needed at any one point of time?

- Spread free cash flow/excess surplus among series of consecutive term deposit periods
- each year, appropriate and hopefully inflation adjusted amount available for use
- if monies not needed reinvest for maximum original term selected

Laddering example

- Corporation accumulating excess cash
- \$100,000 in retained earnings
- 20% needed in any given year
- break up original amount into equal deposits, invested in 1,2,3,4 and 5 year terms
- each year, 20% of retained earnings plus associated interest available for investment in business or reinvestment into 5 year term

5 Years down the road...

- if monies not needed up to that point, all deposits invested in series of consecutive 5 year deposits
- properly set up, entire series of deposits will have interest sheltered from tax during accumulation period.
- All interest available to supplement growth in retained earnings at same rate as GIC

Exempt insurance

Accumulation

- Funding source
 - Retained earnings balance
 - Excess cash

- Investment options
 - Equity income & growth?
 - Fixed income
- Laddering fixed income
 - Identify annual contingency
 - eg. 20% then terms 5,4,3,2,1
 - Renew for 5-year terms
- May ladder in standard form and in exempt insurance

The life insurance alternative

- excess surplus can provide higher estate value for heirs
- tax-deferred growth of surplus/retained earnings
- tax-free death benefit to business
- capital out to heirs virtually tax-free

Some opportunities for cash value insurance

- Alternative vehicle for holding retained earnings or building sinking funds for future growth, expansion or liabilities
- generally tied to insurance solution for collateral coverage, key person, buy sell
- key is to use contract that offers virtually free interest loans and no investment risk

Exempt insurance

Tax sheltering

- Deposits in excess of COI
 - Pre-payment of premiums
- *Exempt* from annual taxation
 - Investment primary purpose
 - Insurance primary purpose
- Maximum accumulation
 - Exempt test policy
 - 20 yr paid-up endowment at age 85 (pro-rata rules)
 - 60 days grace
 - Other tax rules: 8%, 250%
- Overage to taxable account

Some opportunities for cash value insurance

- optimizing use of life insurance in personal estate planning for affluent individuals and families with business interests
- need for personal estate liquidity, estate equalization, capital gains, etc.
- company has retained earnings and interested in return optimization and tax-preferred payouts

Alternative vehicle for holding retained earnings or building sinking funds for future

- systematically reallocate retained earnings into similar investment options within specially designed program set up via insurance company

- dramatically increase earnings with no increased risk to your company
- no further tax on earnings while in Revenue Canada approved tax-exempt account
- Laddering concept employed to optimize rate of return without sacrificing liquidity concerns
- tax on deposits deferred until ultimately withdrawn.
- Amount of tax determined by ACB of underlying policy
- Adjusted Cost Basis (ACB) of policy drops over time... to zero
- on death of life insured retained earnings paid out as part of tax-free benefit to corporation
- company can pay out some / all of retained earnings to shareholders via capital dividend declaration

UL as vehicle for holding retained earnings

- Key to making this attractive to business ...
 - have policy with no surrender charges and virtually interest-free loans
- keeps business in same situation as before regarding access to monies for emergencies, expansion, business opportunities

Alternative UL application

- Already agreed that need exists
- important to address now
- use someone else's money to cover off
- capital free loan idea very intriguing
- optimizing solution tool to:
 - improve retained earnings return and
 - reposition retained earnings and growth to get out of company tax-free
- How would you like to get back all your money/deposits for both the insurance and retained earnings on top of the tax-free death benefit?
- How would you like to get them back tax-free as well and potentially flow them out to shareholders tax-free?

Exempt insurance

Strategic structuring

- Level
 - Guaranteed cost for life
 - Reduces deposit flexibility
- Annual renewable term
 - Optimal use of exempt account
 - Increasing cost, *esp.* later ages
- Hybrids: T10, ART 85
- Increasing (face+account)
 - Higher exempt envelope
 - Auto-indexed death benefit
- Level

- Reduce insurance \$\$'s at-risk
- Increase allocation to exempt
- Options: Maximizer, ROP

Here's how...

- Face amount established by need (key person, buy sell, collateral, capital gains)
- level death benefit option with ROP
- on death of life insured:
 - face value paid out tax-free
 - premiums for policy returned dollar for dollar tax-free
- both can be applied to CDA

An alternative to...

or accelerating Making the numbers work

- 1. Calculate target value for retained earnings by certain time (deposits + interest)
- add this to initial contingency benefit funding requirement
- 2. Calculate death benefit after same set period of time
- time period = premium/deposit paying period
- add return of premium to program
- from end of 5th year onwards, values for strategy 2 = strategy 1
- eg. business repositioning retained earnings
- using example of 5 year funding or repositioning of retained earnings
- on death business gets back excess working capital plus cash to cover off needs

It doesn't matter what the deposits have been used for:

- insurance costs
- administrative costs
- growth
- the business gets back all the cheques it wrote tax-free on top of the death benefit
- working capital fully replenished

Exempt insurance Accessibility



	<u>Withdrawal</u>	<u>Policy loan</u>	<u>Bank collateral</u>
Direct cost	Surrender charges <i>0% to 100%</i>	Insurance Co. interest <i>IIT: 0.75% +?</i> <i>Deductible?</i>	Bank interest <i>Prime +/- ?</i> <i>Deductible?</i>
Tax effect	ACB to CSV ratio is return of capital; rest is taxable	No tax on cumulative loans up to policy ACB; Fully taxable thereafter	Loaned money is not income and therefore not taxable



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Exempt insurance

Extraction

- Death of life insured
- Credit to CDA
- Share redemption
 - Deemed dividend
 - CDA election
 - ***Tax-free*** distribution
 - * Stop-loss rules
 - * Spousal rollovers
- Multi & joint life policies
 - Single ACB - *each death?*
 - Exempt account at each death

Living Buyout Opportunity

- Use retained earnings sitting within specially designed UL to buy back shares
 - borrow or withdraw directly from policy
 - use policy values as collateral when applying for bank loan to fund share repurchase

Policy as collateral

- No deemed disposition so monies continue to grow on tax-deferred basis
- on death of life insured, amount needed to retire loan paid from tax-free proceeds
- balance can be applied towards CDA room
- eligible monies in CDA can be paid out to shareholders via (tax-free) capital dividend

Challenges with loan schemes

- Dependency on interest deductibility
- really need high tax bracket to work
- psyche of policyholder?
- cash flow issues
- commitments servicing debt

Challenges with loan schemes

- what happens when income very low or negative?
- Owner not in same position before vs. after employing this strategy

Interest Deductibility

- Courts consistent... capital expense, not deductible except for ITA para. 20(1)(c)
- *Gifford* case (Supreme Court, Mar '04)
- interest generally “on account of capital” “*since it is incurred in respect of borrowed money which adds to the financial capital of the borrower.*”
- REOP (reasonable expectation of profit)

Proposed REOP Rule

- Released October 31/03

Proposed rule:

A loss realized in a year can be claimed only if, in that year, there is a reasonable expectation that the taxpayer will realize a cumulative profit from the particular source (business or property)

- Measurement period for cumulative profit
- Cumulative profit does not include capital gains and losses
- Finance’s objective
 - Return to world Finance and CRA thought we were in before Supreme Court of Canada decisions in *Ludco*, *Stewart* and *Walls*
 - Intended to have minimal impact
- Many problems
- Borrowing to acquire common shares
 - Particular concern raised by several organizations
 - REOP test rarely met

- Finance not intending to change current treatment
- CRA position?
- Administration of law inconsistent with what it says
- Borrowing to acquire a portfolio of investments
 - Look at each investment separately?
- Effect on insurance-related planning
 - Leveraged insured annuities
 - 10/8 plans
 - borrow on security of UL policy
 - interest on loan is 10%
 - interest credited to matching investment account under policy is 8%
- Will the REOP rule be enacted?
 - Finance committed to a legislative response
 - No interest in a narrowly targeted change
 - Alternative is to modify “for the purpose of earning income” tests in ITA 20(1)(c) (interest deduction) and elsewhere
 - If REOP enacted, refinements likely
 - Technical Notes with examples

Federal Budget ‘05

- concerns with proposals’ structure: i.e. codification of objective “REOP” test limiting deductibility of wide variety of ordinary commercial expenses
- Finance developing more modest legislation combined with CRA publication addressing in context of alternative proposal, certain admin. questions relating to deductibility

CRA concerns re: 10/8

- Question: interest deductibility available when loan interest rate significantly above what might normally be expected in marketplace for arm's length, collateralized loans?
- Tech. Interpretation 2004-065531E5, (Dec. 6, 2004)... CRA concerned that loan interest rate offered was inflated; referred to Finance

Insure means to be sure

- 10/8 works on premise that bulk of servicing of debt goes back into cash value of contract
- balance goes to insurer...for what?
- policyholder is guaranteeing the growth
- policyholder assumes the risk
- where is the back door strategy?

Protecting the status of QESB

- Qualified eligible small business offered reduced tax rate status

- need to maintain appropriate ratios of active to passive income and assets
- use of HOLCO can protect OPCO
- specially designed insurance policies can be held in HOLCO

Policy as collateral

- No deemed disposition so monies continue to grow on tax-deferred basis
- on death of life insured, amount needed to retire loan paid from tax-free proceeds
- balance can be applied towards CDA room
- eligible monies in CDA can be paid out to shareholders via (tax-free) capital dividend

When collateralizing not favourable or available...

but monies needed during lifetime of the contract directly...

- borrow vs. withdraw...
 - borrowing doesn't affect policy exempt room
 - borrowing can trigger different tax implications
 - pick a policy with virtually no loan charges *

Dealing with consumer accountability in UL

- **Look for flexibility for your client and yourself**
 - no surrender charges
 - variety of investment and risk structure options
 - no transfer charges
 - unconditional fully guaranteed bonuses
 - guaranteed cost of insurance
 - guaranteed expenses

Dealing with flexibility in UL

- **Simplify** your job by dealing with fewer variables
 - liquidity, i.e. quick easy access to cash
 - option to borrow, withdraw or collateralize
 - virtually interest-free loans
 - plain language explanations/support documentation

Cashing-out the corporation

Case application

CASE: Family buy-out

- Widower MNS 60, 5 kids
- 50/50 shareholder with son-president; others not involved
- Son to buy out dad

- Need: \$1M life ins. (min)
- Corporation
 - R/E & cash: \$50K/yr for 20 yrs
 - MTR: 48.29%
- Rates of return used
 - Exempt acct base: 3.25%
 - Alternate investment: 5%
- Trilogy UL - Envision 6.4

Case application

CASE: Family buy-out

Case application

Comparative cash values

Case application

Comparative cash values

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