

TAX & ESTATE PLANNING CONSIDERATIONS FOR THE NEW ENTREPRENEUR

1. INTRODUCTION

The new entrepreneur, even if he has previous experience in business as an employee or senior manager or executive of a large corporation, often has little more than a general awareness of legal and tax issues involved in starting up a business. The entrepreneur will be relying on his accountant and lawyer to recommend an appropriate structure and provide advice as to the tax implications.

The client's accountant may or may not have expertise in tax matters and accordingly it may be necessary for the lawyer to provide this tax input.

2. TAXATION OF DIFFERENT BUSINESS STRUCTURES

The different tax treatment of different forms of enterprises can be a significant factor in choosing an appropriate business structure. These factors can be as important as liability concerns.

(A) Sole Proprietorship

Since in law there is no legal difference between a sole proprietorship and the individual running it, the tax treatment of a sole proprietorship is that of the individual, even though the sole proprietorship is a distinct accounting entity.

Under the Income Tax Act (the "Act"), a taxpayer, in computing his "income" for a taxation year, is required to include his income for the year from all his businesses and all his property, wherever situated. What is meant by "income" from a business or property in this context is the "profit" there from. That is, a taxpayer's "profit" in the ordinary business and accounting sense is what the taxpayer is required to account for, in the first instance, when reporting his income from business and property. It should be noted in this regard that "income from a property" does not include capital gains or losses arising from the disposition of property. The profit so determined is merely the starting point for the computation of the taxpayer's income for the year from such sources and is subject modification by numerous other provisions. Many of these other provisions have the effect of altering the accountancy concept of "profit".

Because of the difference between the tax treatment accorded employees and that accorded self-employed individuals, the task of determining whether a taxpayer is bound by a contract for "service" (and is an employee) or by a contract for "service" (and is self-employed) has been faced by the Courts in a number of cases. In some callings this distinction has been particularly difficult to resolve, a fact nowhere better illustrated than by the large number of appeals involving musicians, actors, entertainers and similar artists. When dealing with such entrepreneurs it is after useful to obtain advice from a tax practitioner.

In most cases involving the question of business versus employment, the issue concerns the deductibility of expenses.

The Courts have held that the profit from a business or property is the surplus by which the receipts from the business or property exceed the expenditures made for the purpose of earning those receipts.

However, such a broadly stated concept is of little help in determining "profit for the year". It is now generally accepted that the determination of profit require the application of recognized accounting principles and the calculation of profit according to the "accrual method". A distinction, however, must be made between a requirement that income for tax purposes be accounted for generally in conformity with accounting principles and a requirement that the taxpayer's treatment of financial statement and tax returns be identical. However, this distinction will be more important for a corporation than for sole proprietors.

As a result of changes in the February 27th, 1995 Federal Budget, non-calendar year-ends are no longer available for sole proprietorships or for professional corporations. This eliminates the permanent one-year deferral of income, which was available to such taxpayers.

Finally, it is important to remember that, unlike corporations, tax on individuals is levied at graduated rates.

(B) Partnership

(i) General Rules

Business carried on in partnership, although distinct accounting entities, like sole proprietorship do not have a separate legal personality and are not taxpayers as such. The income from partnership must be reported by the partners in their personal capacity.

The Act requires the determination of income at the partnership level, which must be computed as though the partnership were a separate person. This requires the partnership to compute its income from various sources, as well as any net capital loss, non-capital loss, farm loss and restricted farm loss, where applicable, for the fiscal period of the partnership. Each partner is then required to recognize his share of the income and loss components in his own tax return.

Each partnership computes its income for tax purposes in accordance with the general rules for computing income under the Act as well as with any specific rules applicable to partnerships. The income of the partnership is determined with respect to its fiscal period.

Nothing in the Act requires the partnership itself to file a prescribed partnership tax return showing the computation of income and allocation thereof among the partners. Statements must nevertheless be prepared by the partnership showing this information in order that each partner may properly report his shares of the partnership income in his own return.

The Regulations provides for the filing of a partnership information return by each member of a partnership that carries on a business in Canada, or that is a Canadian partnership, at any time in the partnership's fiscal period.

The partnership return to be filed by the partners must contain such information as the income or loss of the partnership, the names of partners, their shares of income or loss of the partnership, etc. Partnerships with five or fewer members are not required to file an annual Partnership Information Return.

(ii) Allocation to Partners

The items of income and loss that flow through the partnership to the partners retain their characteristics as to source and nature.

In determining income or loss at the partnership level, capital cost allowance on property owned by the partnership and the various reserves permitted by the Act are claimed by the partnership and not by the partners individually.

Salaries paid by a partnership to its members do not constitute a business expense, but are a method of distributing partnership income among members. The income of a partnership in a taxation year may be less than the salaries, which the partnership agreement requires to be paid to the partners. In this event, the excess of the salaries over such income appears as a deduction in the partners' capital accounts. Such a reduction of the capital of each partner is allowed as a deduction in determining the allocation to him of the income or loss of the partnership.

Where a partnership leases property owned by a partner, the rent is an expense of the partnership and income of the member, and not an allocation of partnership income. Each taxable capital gain and allowable capital loss resulting from the sale of partnership property will represent a taxable capital gain or allowable capital loss in the partner's hands. Each partner's share of the taxable capital gains in the partnership will be added to other taxable capital gains which he has realized from other sources from which he will deduct allowable capital losses realized in the partnership and in respect of the disposition of other capital assets held by the partner, thus arriving at the partner's net taxable capital gain position or a capital loss carryover position.

If a partnership realizes rental income from real property, the rental income will retain its characteristic in the individual partner's hands and a particular partner who held other rental properties would aggregate all rental income to determine the maximum capital cost allowance claim available to him in respect of rental buildings, which he owned directly. In determining net rental income in the partnership, the partnership will not be entitled to claim capital cost allowance on rental buildings owned by it in excess of the aggregate net rental income of the partnership before such capital cost allowance claims. For this purpose, the rental properties of the partnership are grouped together. If a net rental income position results after claiming capital cost allowance in the partnership, a particular partner can then add his share of that net rental income to other rental income received directly by him or from other partnerships to determine what capital cost allowance, if any, he might claim in respect of rental properties owned directly by him.

Where a partnership reports a loss for the year that loss is allocated to the partners and used by them to offset against other income or to carry over against income of other years in accordance with the provisions of section 111 of the Act. The partnership itself does not carry the loss over to another year in order to reduce the income reported to the partners for that year. This is a key tax planning point, which will be discussed in more detail below under the heading tax planning.

Limited partnerships, which are often used for investment purposes but are sometimes useful as an operating form, are taxed in the same way as general partnerships except that the concept of "at risk" affects the amount of write off which a limited partner can claim. Details are beyond the scope of this paper.

(C) Joint Venture and Co-Ownership

The taxation of joint ventures or co-ownership is a function of their nature in law.

Transactions on joint account or other forms of joint venture are commonplace in commercial practice. Whether or not such transactions amount to partnership may not be a simple determination.

Though co-ownership of property does not, of itself, constitute the joint or common owners partners, the manner in which parties treat items of property used by them in common may, in the presence of other indicators, point to a relation of partnership between them.

A joint venture carried out through corporate form is not distinguished from any other type of corporation. All of the rules discussed below with respect to the taxation of corporations and their shareholders are applicable.

Many joint ventures will, at law, be in effect partnerships and accordingly the rules of partnership taxation set out above are applicable.

Corporations

(i) General Rules

A corporation is a “person”, and therefore a “taxpayer” in its own right. As is well known, a corporation is a legal entity that is brought into existence by its constating documents and is an entity distinct from its shareholders.

The concept that a corporation is a legal entity separate and distinct from its shareholders gives rise to difficult problems in taxation. Since a corporation is a separate entity, its property, assets and liabilities belong to, or flow from, the corporation. This is so even if there is only one shareholder of the corporation who owns all of its issued and outstanding shares. The “one person company” is no less of a corporation and a separate legal identity than a publicly-held corporation.

The implication of this is that there are 2 stages of taxation where a corporation is involved. The first stage of taxation is at the corporate level and the second stage of taxation is at the shareholder level.

(ii) Corporate Taxation

The taxation of corporate income depends upon four principal factors:

- The type of corporation;
- The source of its income;
- The timing of its distribution to shareholders; and
- The relationship between the corporation and its shareholders.

The theoretical federal tax rate for all corporations is 38% of taxable income. This rate is reduced by an amount equal to 10% of the corporation’s taxable income earned in the year in a province to allow for provincial corporate tax rates. In effect, the basic federal rate of tax on corporate taxable income earned in Canada is 28%

The purpose of the 10% reduction in the federal corporate tax rate is to open an area of the income tax field to the provinces to allow them to levy their own corporate income taxes. In fact, all of the provinces have entered the tax field, and levy corporate taxes at varying rates. Thus the total tax on corporate taxable income is calculated by adding the applicable provincial rate to the federal rate.

The actual rate of federal tax on corporate income depends upon various factors, which can increase or decrease the theoretical rate. For example, some corporations receive tax credits for certain types of income, while surtaxes can raise the effective corporate tax rate above the nominal rate.

The basic federal corporate tax is levied at a flat rate that is applied at a uniform rate to the corporation’s taxable income. Because the tax is applied at a flat rate, the average rate of tax paid by a corporation is usually the same as its marginal rate. Thus, with some exceptions, that are discussed below, the rate of tax paid by a corporation on its “top dollar” is the same as the rate paid on its first dollar of taxable income. The characteristic of the corporate tax structure is extremely important when considering the interplay between the tax paid by a corporation and the tax paid by its individual shareholders. It might, for example, influence the decision as to how much an owner-manager should extract from a corporation by way of salary (that is deductible to the corporation) or dividends (that are not deductible) and taxable to the individual at the progressive marginal rates discussed above.

Having said that corporate tax is levied at a flat rate, it is important to note that there are, in fact, several different flat rates. The rate applicable to a particular corporation depends upon the type of corporation, the amount that it earns in the year, the source and type of its income, and its shareholdings. Each of these factors plays a role in determining the rate at which a corporation is taxable

(iii) Taxation of Dividends

When a corporation pays dividends, its shareholders will generally be liable for tax on their dividend income. The taxation of shareholders depends upon the following:

- Type of shareholders (corporate or individual);
- Status (Canadian or foreign) of the payor corporation;
- Size of shareholdings (controlling shareholder or portfolio investor);
- Type of dividend (taxable or capital); and
- Source of income from which the dividend is paid (active or passive).

One of the complicating features of the corporate tax system is the potential for double taxation of income in the corporation and again in the hands of its shareholders. The act does, however, provide some relief from double taxation in certain situations. For example, dividends between taxable Canadian corporations flow through on a tax-free basis. Individuals who receive dividends from taxable Canadian corporations are entitled to a dividend tax credit, which reduces the net tax rate on such income.

Whether the relief from double taxation of corporate income is complete or partial depends upon the status of the payer corporation and the source and amount of its income. Generally, the tax system is most generous to shareholders of "small" Canadian corporations engaged in active business. Shareholders of "large" or non-Canadian corporations are subject to some double taxation.

The Canadian tax system is largely integrated with respect annual active business income of up to \$200,000 earned by a Canadian-controlled private corporation and paid to its individual Canadian shareholder. In such a case the total tax burden incurred by the corporation and the shareholder is approximately the same as the tax, which would be incurred by the individual if he earned the active income directly through a sole proprietorship. However, it is important to note, as set out in more detail in the tax planning section below that a potential for deferral of taxation exists in this situation.

(D) Tax Planning

One of the key points to consider in a business start-up situation is whether profits or losses are projected in the start-up phase. If losses are anticipated, ignoring liability concerns, a corporation is not the best legal structure to use.

Any losses incurred by the corporation remain in the corporation and cannot be directly accessed by the principals of the business. In other words such losses cannot be used by the entrepreneur to offset other sources of income.

From a tax planning point of view a proprietorship or partnership is preferable in these circumstances. Any losses incurred can directly be utilized by the entrepreneur.

The corollary to this loss utilization is that the entrepreneur has personal liability for any debts incurred. Some protection can be provided by the use of a corporation, which acts as a bare trustee, pursuant to a written agreement, on behalf of the entrepreneur. Although there is a risk that the Courts may pierce the corporate veil and fix liability directly on the owner, there is nevertheless one barrier, which provides protection. Such bare trust corporations are mere conduits for tax purposes and any income or loss is taxed directly in the hands of the beneficiary.

If profits are anticipated then an analysis of the projected tax burden if the income were earned personally and if the income were earned through a corporation should be performed by the entrepreneur's accountant.

It is also important in making this analysis to remember that active business income of up to \$200,000 earned by a Canadian-controlled private corporation is subject to a low rate of taxation. Therefore any income in excess of this amount should be paid out by way of salary or bonus to reduce corporate taxable income to this level.

This initial stage of taxation in the corporation is less than the top marginal tax rate applicable to individuals. Therefore to the extent that the funds are not required by the entrepreneur for personal consumption and can be left in the corporation, a deferral of tax will be available. This deferral is enjoyed until such time as dividends are paid to the shareholder and taxed in the shareholder's hands. At that time the second stage of taxation, the dividend in the shareholders hands, is incurred, whereupon the total tax burden on the income is the same as if it had been earned by the individual directly, but a deferral of part of the tax has been enjoyed.

With respect to passive (investment income, there is basically no deferral possible through the use of a corporation.

3. ACQUISITION OF BUSINESS

When advising an entrepreneur who is acquiring an existing business rather than starting up a new business, the invariable question is whether shares or assets should be acquired. Although the general rule of thumb is that vendors wish to sell shares and purchasers wish to acquire assets, the specifics of the taxation of each and the details of the transaction should be examined.

(A) Shares

(i) Effect on Purchaser

On a purchase of shares the entire purchase price paid by the purchaser to the vendor is allocated to the shares. In other words, the underlying tax values of the assets in the corporation remain unchanged.

The acquired shares will normally be capital property of the purchaser. The Act prohibits the deduction of any payment on account of capital when computing income from a business or property. Further, the Act excludes from the definition of "eligible capital expenditure" the cost, or any part of the cost, of acquiring tangible property. Therefore no part of the price paid for the business qualifies for deduction from income even if the price paid for the business was arrived at with reference to the "goodwill" of the underlying business of the corporation.

In an arm's length transaction, therefore, the purchaser's cost base for the acquired shares would equal the price paid for the shares plus any reasonable fees and expenses of acquiring the shares.

The Act permits a taxpayer to deduct amounts paid or payable in the year, pursuant to a legal obligation, as interest on an amount borrowed for the purpose of gaining or producing income from the property or business acquired. Note that the interest must be paid or payable pursuant to a legal obligation. This means it must be paid in respect of an obligation under which the taxpayer is bound and in respect of which payment may be made the object of legal recourse by the creditor. Note as well that the deduction is limited by the general provision that the amount of interest must be reasonable.

(ii) Effect on Corporation

Although generally speaking the tax status of the corporation is unaffected by a share purchase, there are certain exceptions.

A change in control triggers a new year-end. This means that the corporation must prepare financial statements and file tax returns at that time.

The other major effect on a change of control is with respect to a corporation's loss carry forward, which is to say the losses previously incurred by the corporation, which can normally be used to offset similar income in other years.

Net capital loss is the amount of a taxpayer's allowable capital losses for the year that can be carried over to other years to be deducted in arriving at taxable income. Generally speaking the Act permits net capital losses to be carried forward indefinitely and to be carried back one year. In the case of a corporation, the carry over of losses is limited to the corporation's net capital gains in the year. However, there are limitations in situations where control of the corporation that has sustained the loss is acquired by a person or persons who did not control the corporation at the end of the preceding year. In such circumstances, net capital losses for preceding years and the year in which the change in control occurs may not be deducted. Therefore when control of a corporation changes hands, its unused net capital losses that are available from previous taxation years cannot be employed by the corporation in the year in which the change took place, or in any subsequent year.

The Act also generally permits non-capital losses to be carried forward seven years and back three years. This is qualified however when there is a change in control of a corporation, non-capital losses of the corporation are deductible only if the loss business is carried on for profit or with a reasonable expectation of profit for the year in which control changed and for future years in which the loss will be deducted. Losses incurred prior to the change of control may then be deducted pursuant to certain limitations.

Since all liabilities of the corporation remain with the corporation, this of course includes tax liabilities. It is therefore important to ensure that all potential tax liabilities have been determined.

Certain liabilities might arise as a result of the sale of the business. For example if there is any debt forgiveness of amounts owing by the corporation to the shareholder, this would have negative tax implications to the corporation. The same is also true of any other debt of the corporation, which is forgiven by any other person.

(iii) Negotiating Purchase Price

It should be remembered that the sale of shares gives rise, in most circumstances, to a capital gain to the vendor. The vendor may have a capital gains exemption of up to \$500,000 available to him on the sale of the shares of a qualifying small business corporation. Even if this capital gains exemption is unavailable only $\frac{3}{4}$ of the entrepreneur in negotiating the final purchase price.

In many cases it will be desirable both from the point of view of the purchaser and the vendor to have the vendor available to assist in the initial operation of the business by the purchaser. In those circumstances, the vendor may accept a lower price for the business if an attractive consulting arrangement is arrived at.

From a tax point of view, this arrangement is desirable for the purchaser since the consulting payments will be deductible to the corporation, which makes the payments as long as the payment is reasonable in relation to the services actually performed. On the other hand, the vendor will be fully taxable on the consulting payments received.

If the quantum of the consulting fee is not reasonable, then not only will a portion of the consulting payment be non-deductible to the corporation paying it, but, there is a risk that the payment could be considered disguised sale proceeds. In that case the purchaser may have an income inclusion for the excessive payment on the basis that the corporation has conferred a benefit on the shareholder by paying consulting fee and thereby reducing the purchase price.

It is also very important to remember that while a reserve is available to a vendor where a portion of the purchase price is to be paid over a period of time, the Act requires that a minimum of 1/5 of the proceeds be brought into income in every year. Accordingly a transaction which a purchaser would like to structure in such a way that payments take more than 5 years, or less than 1/5 of the proceeds are paid each year, will result in a tax liability to the vendor which he may not have the cash flow to pay. Accordingly any such structure is unrealistic and the entrepreneur should be so advised.

The Act has a provision, which generally provides that payments that are dependant on production or use are normally included in income. However, Revenue Canada has taken the administrative position that they will not apply the income inclusion provisions if the following conditions apply:

- The vendor and purchaser are dealing with each other at arm's length;
- The gain or loss on the sale is clearly of a capital nature;
- It is reasonable to assume that the earnout feature relates to goodwill the value of which cannot reasonably be expected to be agreed upon by the vendor and purchaser at the date of the sale;
- The duration of the sale agreement does not exceed five years; and
- The vendor submits, with the income return for the year in which the shares were disposed of, a copy of the sale agreement. Also submitted with that return is a letter requesting the application of the cost recovery method to the sale, and an undertaking to follow the procedure of reporting the gain or loss on the sale under the cost recovery method as outlined in the Interpretation Bulletin.

It is therefore important for the purchaser to be properly informed of the tax implications to this structure.

(B) Assets

An asset purchase is more complicated from a corporate point of view than a share purchase is. The same is true of the tax considerations. In effect, each asset being acquired, including intangible assets, has its own tax treatment.

There are two tax considerations arising out of a purchase and sale of assets. The first is the allocation of the purchase price to the assets of the business. The second is the allocation of the consideration amount the assets of the business.

(i) Allocation of Purchase

The allocation of the purchase price amount the various assets of the business is one of the most important tax considerations. The vendor's objective will be to minimize its tax liabilities in the year of sale. The vendor will wish to allocate the purchase price to assets, which give rise to either no income or income, which is subject to tax at reduced rates. The vendor's preference will be to allocate the purchase price to assets in the following order:

- Non-depreciable capital property. Three quarters of any gain will be included in income.
- Depreciable capital property where there will be little or no recapture of capital cost allowance.
- Eligible capital property. Only $\frac{3}{4}$ of the sales proceeds will be deducted from the cumulative eligible capital and any excess will be included in income.
- Depreciable capital property where there will be recapture of capital cost allowance. Inventory and other assets, which will give, rise to a full income inclusion.

The purchaser will wish to allocate the purchase price to assets in respect of which there will be the maximum deduction available for tax purposes in the years subsequent to the year of sale. The purchaser's preference will be to allocate the purchase price to assets in the following order:

- Inventory.
- Depreciable capital property, particularly depreciable capital property in respect of which there is a high rate of capital cost allowance.
- Eligible capital property.
- Depreciable capital property where there is a very low rate of CCA.
- Non-depreciable capital property.

As noted above, the vendor and purchaser will often have conflicting interests and the allocation may require negotiation. It is for this reason that Revenue Canada will typically accept the allocation reached by the parties, provided that there is evidence that the transaction is a negotiated one.

Where the parties do not have conflicting interest (for example, where one party is exempt from tax) or where the parties report the transaction on a different basis for tax purposes, Revenue Canada may invoke the Act and set aside the allocation.

Often an agreement of purchase and sale will provide that the parties to the agreement accept the reasonableness of the allocation and agree to file their respective appropriate income tax returns using the agreed allocation. This will ensure that the negotiated allocation will actually be used by the parties and minimize the risk that Revenue Canada will challenge the allocation.

(ii) Allocation of Consideration

Careful allocation of the consideration may reduce the taxes payable by the vendor in the year of sale without affecting the taxes payable by the purchaser. Where the consideration includes vendor-take-back debt, provided the debt is not due until a year that is after the year of sale, the vendor may be entitled to a reserve. A reserve is available in respect of capital property and inventory, provided certain conditions are met.

It is quite usual that inventory be sold at book value and accordingly any income tax consequences are minimal. The Act provides that any gain or loss arising on the sale of inventory will be on income account rather than on capital account.

From the purchaser's point of view, the portion of the purchase price allocated to inventory will be deductible when the inventory is sold.

Since inventory is normally purchased for resale, it is usually exempt from provincial retail sales tax.

The sale of inventory is a taxable supply with the result that, absent a rollover, GST will be payable.

Capital properties are divided between depreciable assets such as buildings and non-depreciable assets such as land.

The portion of the purchase price, which is allocated to the building, may be deducted at the rate of 4% per year on a declining-balance basis.

There is no immediate tax relief to the purchaser in respect of the portion of the purchase price, which is allocated to the land. The portion of the purchase price, which is allocated to the land, is added to the adjusted cost base of the land to the purchaser. The adjusted cost base is relevant to determining the capital gain (or loss) that will be realized by the purchaser on a subsequent sale of the building.

When real property is included in an asset purchase, Ontario land transfer tax is payable on the portion of the purchase price allocated to real property (both land and building).

The sale of real estate is a taxable supply with the result that, absent a rollover, GST will be payable.

For income tax purposes, depreciable assets such as machinery, equipment computers, vehicles or leasehold improvements are a type of capital asset whose cost may be deducted over time. They may be depreciated at different rates.

Goodwill is generally described as the basket of intangible assets, which add value to a business. Examples would include its customer list, the location of its premises, its mailing list, its business names and phone numbers and generally the value and goodwill built up as a result of years of carrying on business. From a tax and accounting point of view, it is the price over and above the specific tangible assets, which a purchaser is prepared to pay in order to acquire the business.

Goodwill and other intangible assets connected with a business, which are not listed in one of the capital cost allowance classes are generally classified under the Act as "eligible capital property". Other examples of eligible capital property are legal costs on incorporation, licenses for an unlimited period and payment for non-competition clauses.

The tax treatment of eligible capital property is similar to that of depreciable property, but there are some differences. For example, although the cost of eligible capital property can be deducted over time, only $\frac{3}{4}$ of the cost may be deducted at the rate of 7% on a declining-balance.

As well, 75% of the gain is included in income of the vendor. If the vendor is a private corporation, apportion of the purchase price allocated to eligible capital property is added to the corporation's capital dividend account.

Similarly, only $\frac{3}{4}$ of the cost of eligible capital property can be deducted by the purchaser and this is at the rate of 7% on a declining-balance basis.

4. REORGANIZATIONS

The topic of reorganization is broad and is often the subject of one or more papers on its own right. The focus of this paper is limited to reorganization likely to be encountered by the entrepreneur in the initial stages of the business.

(A) Changes

As discussed above, an entrepreneur may decide to commence business in a partnership or sole proprietorship form in order to take advantage of start-up losses. Once the business becomes profitable it is often necessary to incorporate.

A transfer of a sole proprietorship or a partnership to a corporation takes place under section 85. Section 85 is the general rollover provision for capital assets and is used in many different types of reorganization.

Under section 85, the disposition of property may give rise to the recognition of gain or loss by the taxpayer. The resulting tax liability may however be deferred on a transfer by a taxpayer to a corporation for consideration that includes shares issued by the transferee.

Some of the most common applications of section 85 are listed below:

- The incorporation of a business by an individual or a partnership;
- The creation of a holding company by an individual or a partnership;
- The transfer of property to a corporation in the context of an estate freeze and/or income splitting reorganization;
- The transfer of property within a group of corporations for business or tax reasons;
- The division of a corporation under paragraph 55(3)(b);
- The purchase of property for consideration, which consists in whole or in part of shares.

Section 85 of the Act does not restrict the deferral of tax liability to a specific type of transaction nor to a transaction carried out for a specific purpose. It applies to any disposition of eligible property to a taxable Canadian corporation. Common control is not required and the transfer need not be reorganizations. However, most elections under section 85 involve related parties or pertain to reorganizations, because the deferral of tax liability on the transfer of property is conditional on shares of the transferee being received as consideration by the transferor.

Under section 85, a joint election by the transferor and the transferee has the effect of deeming the proceeds of disposition of the property to be equal to an elected amount. The same amount is deemed to be the cost of acquisition of the property. The election can thus be regarded as substituting a deemed amount for the figure determined under the income tax rules otherwise applicable to both the transferor and the transferee.

In the case of the entrepreneur section 85 would be applicable on the transfer if the assets of the proprietorship or the partnership into the corporation in exchange for shares of this corporation. The results would be that the business originally carried on in an unincorporated form has now been acquired by the corporation on a tax-deferred basis. The corporation will then continue the business.

A formal written agreement will be entered into between the entrepreneur as vendor and the corporation as purchaser. It will have some of the normal provisions of an arm's length agreement of purchase and including all necessary conveyances of title to assets.

A detailed analysis of section 85 is beyond the scope of this paper.

(B) Tax Motivated Reorganizations

Many reorganizations will be initiated for tax reasons, often by the company's accountant. Tax-based reasons for reorganization include the following:

- Accessing corporate losses
- Crystallizing the capital gains exemption
- Purifying the corporation to retain its eligibility as a qualifying small business corporation for capital gains exemption purposes
- Departure of one of several shareholders
- Break up of the corporation among several shareholders

The reorganization set out above will, for the most part, involve the utilization of one or more section 85 rollovers

(C) Estate Planning

Estate planning in this context is merely a specialized form of tax-motivated reorganization, usually involving either a section 85 rollover or a section 86 internal reorganization. This subject is discussed in detail below.

(D) Creditor Proofing

Reorganization of a corporate group may also be undertaken with a view to protecting assets from creditors. It is, of course, important to ensure that all relevant statutes are complied with.

Reorganization for creditor proofing purposes will usually take one of the following forms:

- Rolling certain operating assets (such as a separate division into a sister company)
- Setting up a holding company, declaring and paying a dividend equal to all of the equity of the operating company and then lending these funds back to the operating company secured by a general security agreement registered under the PPSA
- Setting up a new corporation for a new division

This is another case where reorganization will typically be carried out utilizing rollovers under section 85. Accordingly such reorganization will normally have no immediate adverse tax consequences.

(E) Equity to Employees

Employees who are being given minor amounts of equity will usually obtain it by way of stock options.

(i) Stock Options

In a stock option plan, the employee is given or earns the right to acquire shares of the corporation, usually at some fixed period of time in the future. Sometimes the employee acquires certain shares at the inception of the stock option plan with rights to acquire additional shares in the future. The vesting of the option rights maybe deferred for some period of time and will usually only vest if the individual is still employed by the corporation.

There should be a written agreement, which specifies how the employee earns rights to additional shares, the price to be paid for those shares and requirement for vesting.

For privately held corporations continued employment with the corporation is generally a prerequisite for exercising the option and for keeping the shares. In the event of a departure from employment the shares are usually reacquired by the corporation on some basis.

If the shares of the corporation are publicly traded then the employee will be permitted to keep his shares even after his employment is terminated. However, he will usually be unable to exercise options to acquire any additional shares after leaving the corporation.

Stock option plans are one of the proverbial “golden handcuffs” since the employee’s rights are limited or terminated in the event of termination of employment.

Most stock option plans are limited to management but some plans are made available to all employees of the organization. In that case there will usually be a different plan for management and for non-management employees.

Another advantage to stock option plans from a corporate point of view is that there is no cash outflow to the corporation. On the contrary, if the employees are required to buy the shares at fair market value, the corporation actually receives funds. Payments are only required by the corporation if dividends are declared.

The issuance of stock options has tax implications, which vary depending on whether the corporation is private or public and also depend on how long the shares are held after exercise. However when an employee is being provided with a significant percentage of the business, a reorganization of the capital of the corporation may be undertaken.

This reorganization is similar in principle to that undertaken in an estate freeze utilizing section 86 of the Act. Typically the existing shareholder will convert his shares into a class of special shares with the same value as the existing common shares. Thereafter he and the employee will be able to subscribe for new common shares of the corporation for a nominal amount.

A re-organization under section 86 has no immediate adverse tax consequences to the entrepreneur if carried out properly. One class of shares with an existing adjusted cost base and paid up capital will be converted into one or more other classes of shares of the same corporation with a total cost base and paid up capital equal to that of the shares being given up. The employee is then free to subscribe for new common shares of the corporation for a nominal amount with no tax implications to him.

When stock options are given without a re-organization, and a benefit is conferred on the employee, the Act has special provisions that are applicable.

Stock option benefits are taxable as employment income because they are, in effect, an alternative to cash compensation.

The common law rule that stock option benefits arose in the year in which the option was granted created considerable uncertainty in determining the value of benefits derived from unexercised options. The Act resolves the uncertainty by specifying both the method of valuation and the time for inclusion of the benefit in income.

An individual is taxable on the value of stock option benefits derived by virtue of employment. The benefit is determined by reference to the shares actually acquired pursuant to the stock option plan.

The first question is: Was the benefit conferred by virtue of the employment relationship? Issuance of stock for other considerations (for example, as a gift or in return for guaranteeing a loan) does not give rise to a benefit from employment. Nor is the issuance of stock by virtue of the individual's office (such as a directorship taxable under these rules).

The triggering event for the recognition of stock option benefits is the acquisition of shares at a price less than their value at the time the shares are acquired. The time of acquisition is determined by reference to principles of contractual and corporate law.

Except in special cases (discussed below), the value of a stock option benefit can be determined only at or after the time the stock option is exercised, that is, when the shares are acquired. The value of the benefit is the difference between the cost of the option to the employee, any amount paid for the shares, and the value of the shares at the time they are acquired from the plan. Shares are considered to be acquired when the option is exercised.

"Value" means "fair market value". In the case of publicly traded securities, stock market prices will usually be considered indicative of fair market value. Since listed stock prices inherently reflect the value of minority shareholdings, there is no need to further discount their value for minority interest.

The value of shares of a private corporation, which will be the case with entrepreneurs, is more difficult to determine. Shares of private corporations are generally valued by reference to estimated future earnings and the adjusted net value of assets. The pro rate value of the corporation is then adjusted to reflect a discount for minority interests, lack of market, etc.

There are two special rules in respect of stock option plans. One applies to options issued by Canadian-controlled private corporations ("CCPC") and the other to acquisitions of prescribed equity participation in Canadian corporations.

Shares acquired from a CCPCs stock plan in an arm's length transaction receive preferential treatment if they are held for at least two years. This is so whether the shares are issued by the employer corporation or by another CCPC with which the employer does not deal at arm's length.

An employee may defer recognition of any benefit derived from stock options issued by a CCPC until disposition of the shares. Upon disposition of the shares, the employee is taxable on only $\frac{3}{4}$ of the value of the benefit derived.

The employee benefits by deferring any tax liability, which would otherwise arise upon acquisition of the shares through an "ordinary" stock option plan and by converting what would normally be fully taxable employment source income into income that is, in effect, taxable at a lower rate. The portion of the benefit that is taxable to the employee is not a capital gain but income from employment, taxed at the same rate as a capital gain.

An employee who disposes of shares in a CCPC within two years from the date of acquisition is taxable in the year of disposition on the full value of any benefit derived from their acquisition.

There is also a special rule for stock option plans under which an individual acquires prescribed equity shares in his employer's corporation or in a corporation with which the employer does not deal at arm's length. An employee is taxable on only $\frac{3}{4}$ of the value of any benefit derived from such a plan. The benefit, however, is taxable on a current basis.

The following conditions must be satisfied in order for a stock option plan to qualify for this special tax treatment:

- The shares must be prescribed at the time of their sale or issuance;
- The employee must purchase the shares for not less than their fair market value at the time the agreement was made; and
- The employee must have been at arm's length with the employer and the issuing corporation at the time the agreement was made.

1. FINANCING

The tax treatment of conventional financing are straightforward. Special forms of financing, such as term-preferred shares, are beyond the scope of this paper.

(a) Debt

Interest on debt incurred by an individual or corporation for the purposes of earning income will be deductible by the borrower. It will also be taxable in the hands of the recipient.

Often it will be necessary for the entrepreneur to personally guarantee the obligations of the corporation.

(i) Deduction of Guarantee Payments

Generally speaking, a taxpayer who is required to honour a Guarantee is considered to have acquired a debt at the time that the Guarantee is honoured equal to the amount of payment made pursuant to the Guarantee.

Whether the debt so acquired is a bad debt is a question of fact. If the Guarantee had been given for adequate consideration it will generally be considered to have been given for the purpose of gaining or producing income. Therefore, if the acquisition of debt in these circumstances gives rise to a bad debt, any loss arising from a payment required by the Guarantor under the Guarantee will be considered to be a deductible capital loss. In certain circumstances, discussed

in Interpretation Bulletin 239R2, loan guarantees for inadequate consideration may also give rise to capital losses. This occurs where:

- The corporation (or partnership) which benefited from the Guarantee used the borrowed funds to earn income
- The corporation could not obtain financing at competitive rates without the Guarantee
- The corporation permanently ceased to carry on its business
- The loan from the shareholder to the corporation did not result in any undue tax advantage

(b) Equity

An equity investment does not give rise to a deduction to the borrower on payments made. Dividend payments from a corporation are made out of after tax funds. Dividends received by a corporation or a shareholder have special rules as set out above. A Canadian resident individual who receives a dividend from a Canadian-controlled private corporation is entitled to a gross up and dividend tax credit. As mentioned above, this is part of the integration mechanism, which ensures that income earned by an entrepreneur through a corporation or directly through an unincorporated business will, ultimately be taxed at the same rate.

A corporation, which receives a dividend may be entitled to a deduction in respect of the dividend depending on the nature of the income in the paying corporation, which gave rise to dividend. A more complete analysis is beyond the scope of this paper.

6. SUCCESSION

The desire to reduce the tax burden, which will be incurred on death, is the main motivating factor behind succession planning.

(a) Taxation on Death or Transfer of Assets

While succession duty, estate tax and gift tax are not currently imposed by the Federal or Ontario governments, an individual is deemed by the Act to have disposed of all of his capital property immediately before death for its fair market value at that time. There is an exception for property that is transferred to the taxpayer's spouse or a trust for the taxpayer's spouse as discussed below.

The Act provides that where a taxpayer disposes of anything to a non-arm's length person for proceeds less than fair market value; or to any person by inter vivos gift, the taxpayer is deemed to have received proceeds of disposition equal to fair market value.

An entrepreneur who owns shares in a family business with inherent capital gains will realize those gains on death or when he transfers the shares of the business for less than the fair market value to a child.

It is the inherent capital gains tax on the increase in value of the family business, which often motivates an entrepreneur to consider how the family business can finance the transfer from one generation to the next.

7. ESTATE PLANNING

(a) Methods

(i) Gifts to a Spouse or Spousal Trust

One of the simplest ways for an individual to defer capital gains tax on death is to transfer the family business to a spouse or to a trust for the spouse. This, however, does not defer the tax on the accrued value of the business when transferred to the next generation, which tax will occur on death of the surviving spouse.

An election can be made under the Act so that a transfer to a spouse or to a spousal trust will occur at fair market value rather than on a rollover basis. This enables the personal representatives of the deceased entrepreneur to elect to realize sufficient gains to absorb any capital losses owing on death.

A transfer of the family business directly to the spouse may satisfy the planning requirements of the parent in some circumstances. However, where a parent wishes ultimately to transfer the business to the children, but knows that the business cannot fund the tax liability arising on death, the parent can transfer the property to a spousal trust. This allows capital gains tax to be deferred until the death of the spouse, but ensures that the family business is eventually transferred to the next generation. This approval also defers the problem of funding the tax liability to the children.

A spousal trust will, however, not be appropriate in all circumstances. Vesting of the family business in the children will be delayed until the death of the spouse. The desire of the children to increase the value of the business by reinvesting income to allow for expansion may be at odds with the surviving spouse's need for income. Perhaps most likely to cause problems is the transfer of family business to a spousal trust for a second spouse where the children are actively involved in family business and the relationship between the spouse and the children is not good. In such a case, the potential for disruption of the operation of the family business may be sufficiently serious to forego the tax deferral and to make instead a direct transfer of the family business to the next generation. However, in Ontario, a spouse's right to elect to take an equalization of net family property rather than what is provided under the will must also be considered.

Where there are significant assets outside the family business, some thought should be given to establishing both a spousal trust and a family trust under a will, so that assets with an inherent capital gain can be transferred to the spousal trust and the tax deferral obtained and other assets with little or no inherent capital gains can be available for the children.

(ii) Estate Freeze

An estate freeze allows the capital value of a business to be "frozen" at the time of the freeze and future growth in the value of the business to be transferred to the next generation without triggering capital gains tax. The advantage is the deferral of tax until the death of the next generation in respect of the increase in value of the business after the freeze. As mentioned briefly above, the most common form of an estate freeze is a reorganization of share capital under section 86 of the Act.

Generally, in a section 86 reorganization, common shares of a business would be converted into common and preference shares. The preference shares would be fixed-value shares with their value being equal to the fair market value of the business at the time of the reorganization. As all of the value of the corporation will be reflected in the value attributed to the preference shares, the new common shares will have nominal value. These new nominal value common shares can then either be transferred directly to members of the next generation or can be transferred directly to members of the next generation or can be transferred to a trust for members of the next generation (see the discussion below) without any adverse tax consequences.

An estate freeze can also be carried out by way of a section 85 transfer of the shares of the operating company into a newly established holding company with the transferor taking back preferred or special shares equal in value to the common shares of the operating company transferred to the holding company. The shares of the holding company would be owned by the next generation in the case of a complete estate freeze.

A partial estate freeze, which is one in which some of the future growth is retained by the parents, can also be accomplished either with a section 85 rollover or a section 86 reorganization.

Any growth in the business will result in an increase in the value of the common shares. However, the common shares will have already been transferred to the next generation. Thus, capital gains tax on any increase in value of the business after the freeze will not be triggered on the parent's death. Capital gains tax will, of course, be triggered on the parent's death on the difference between the adjusted cost base and the fair market value (the value at the time of freeze) of the preference shares. As set out above, the preference shares may be transferred to a spousal trust to defer this tax until the death of the spouse. Alternatively, the preference shares may be redeemed over time to provide income to the parent. Each redemption will trigger capital gains on the inherent gain in the preference shares, which will allow for payment of this tax over time.

One of the most important issues which must be addressed by a parent considering an estate freeze is whether the parent's frozen interest in the business, along with his or her other assets, will be sufficient to maintain his and the lifestyle of his spouse.

(iii) Inter Vivos Trusts

A transfer of property to the trustees of an inter vivos trust (other than a spousal trust) results in a disposition under the Act for deemed proceeds equal to the fair market value of the property at that time and therefore triggers tax on any inherent capital gain.

As outlined above, a transfer of property to a trust (other than a spousal trust) is deemed to occur at the fair market value of the property at the time of the transfer. However, property can usually be distributed to a beneficiary in satisfaction of his or her capital interest in a trust on a rollout basis.

The Act provides that where property of a personal trust has been distributed by the trust to a beneficiary of the trust in satisfaction of all or part of the beneficiary's capital interest in the trust, the trust is deemed to have disposed of the property for proceeds equal to its cost to the trust; and the beneficiary is deemed to have acquired the property at a cost equal to its cost to the trust.

Because property is deemed to be disposed of at fair market value when it is settled on a trust, but subsequently can be transferred to a beneficiary in satisfaction of the capital interest in the trust on a rollout basis, trusts are commonly used in conjunction with an estate freeze. Common shares acquired in an estate freeze would not normally have significant inherent capital gains (as most of the value of the business will be attributable to the preference shares issued as part of the freeze) and so can be transferred on a trust with minimal tax consequences. If the common shares increase in value while held in the trust, they can then be distributed to the beneficiaries on a rollout basis.

The advantages of settling the common shares (or "growth" shares) on the trustees of a trust are:

- Common shares can be held by trustees for the benefit of minor children and so the freeze can, if otherwise appropriate, be effected before the children are old enough to own the shares directly;
- The trust can be drafted to include unborn issue and issue of deceased children and so can accommodate changes in the family structure.;

- Using a discretionary trust allows the parent to delay making a decision respecting ultimate ownership of the common shares until the parent has had an opportunity to assess the interest and ability of the children to operate the family business;
- Legal title to the common shares and the ability to vote the common shares is vested in the trustees for the trust. This may give the parent who retains an interest in the family business an increased level of comfort that the business will be appropriately operated.

Once a decision has been made to settle shares of the family business on the trustees of a trust, the choice of appropriate trustees is crucial. Often the settlor will wish to be a trustee during his lifetime. If the settlor of a discretionary trust is to be the sole trustee or even one of three trustees but has the ability to effectively veto decisions of the remaining trustees, and the Act may apply to attribute income and capital gains from property in the trust to the settlor. It may be possible for the parent to be the sole trustee of the trust if the trust is settled by a third party such as a grandparent and the trustees borrow from an independent third party to acquire the common shares.

Subsection 75(2) of the Act provides that where property is held on trust on condition that the property (or substituted property) may revert to the person from whom the property was received or pass to persons to be determined by the person after the creation of the trust, income and capital gains of the trust will be attributed to the person.

Revenue Canada takes the position that the trustee of a discretionary trust who may select beneficiaries from a pre-determined set of beneficiaries and who must make such a decision in his capacity as a trustee has the power to determine the person who will receive property. Revenue Canada has stated: "the individual has the capacity or discretion to select the proportion of the Trust Fund to be allocated to a specific person among the group of beneficiaries, [so] paragraph 75(2) will apply"

Subsection 75(2) of the Act does not attribute income to a settlor who is the sole trustee of a fixed trust and does not attribute business income. Attribution under this subsection can be avoided for income from property if the settlor is one of at least three trustees and simple majority of trustees can make decisions respecting beneficial entitlement.

One significant disadvantage of earning income in an inter vivos trust is that such a trust does not obtain the advantage of the marginal tax rates. Rather, all of the income of the trust is taxed at the top marginal rate. The trust obtains a deduction from income for amounts paid or payable to a beneficiary and such amounts are taxed to the beneficiary.

By way of contrast, the income and taxable capital gains of a testamentary trust are taxed at the marginal rates of tax, which are progressive. In addition, the personal tax credits are not available to testamentary or inter vivos trusts.

(b) Control

The transfer of control from one generation to the next is a key issue when transfer is to occur prior to the parent's death.

The two main types of control are operational control and legal control:

Operational control is the day-to-day management and operation of the family business. It is often in this area where a child or children who are active in family business will begin to assume control.

The parent and child must define the employment rules for each of them during the transition period. Generally, the parent will decrease his involvement in the day-to-day operations of the company and the child will assume those day-to-day operations of the company.

Legal control is generally defined as the ability to elect a majority of the Board of Directors of a corporation. The transfer of the family business from one generation to the next will also require transfer of legal control. There are a number of methods for dealing with transfer of legal control of a business.

However it is very important to ensure that control does not pass to the next generation before the parents are ready and without insuring sufficient income to support the parents in their lifestyle.

Share terms can be drafted so as to divide up voting control, rights to dividends and rights to participate in the growth in value of the corporation in almost any way a client would like. The main types of shares are preference shares and common shares. Preference shares are generally fixed-value shares with specific rights, for example the right to fixed or preferential dividends or the right to vote. Common shares generally have the right to participate in the value of the family business. A common way to ensure control is for the parents to retain a class of voting, non-participating shares once the estate freeze takes place.

By separating the voting rights of shares from other rights, a parent can retain legal control by holding voting shares. In theory, these non-participating shares should have nominal value and so there should not be any significant tax on the deemed disposition of such shares on the death of the parent.

A written agreement is another method of preserving control in the hands of the parents. Typically an unanimous shareholders agreement will be entered into.

A unanimous shareholders agreement takes control of a corporation from the Board of Directors and vest it in the shareholders such an agreement can be entered into by a parent and child who are shareholders of a corporation and can deal with, and bind the parties to deal with, all aspects of the management and voting of shares of a corporation. It can also provide a staged method for transfer of legal control of the corporation, buy-outs, restrictions on transfer of shares and redemption of shares. It is important to remember that to the extent that the directors are relieved of their responsibilities by the shareholders, attendant director liabilities are also transferred from the directors to the shareholders. Caution should therefore be exercised in drafting unanimous shareholders agreements.

A unanimous shareholders agreement is a very effective method of dealing with transfer of legal control and operational control during the transitional phase. It can also set up a blueprint for shares management, ownership and operation of the family business for the next generation.

In many cases, the parent will not be prepared to relinquish control of the family business during his lifetime. In these circumstances, the elements of the parent's will become extremely important since it can delay vesting of shares of a business for a fixed period of time, or until the happening of a particular event. The will can be drafted so that the trustees have the power to operate the business until the appropriate date for distribution to the ultimate beneficiaries. This is particularly helpful for a parent with younger children who are not presently ready or able to assume control of a corporation.

If there is an expectation that the executors and trustees will operate the family business for any significant period of time, the choice of executors and trustees is of crucial importance. Where the parent owns the business with a third party, that third party, while usually the most knowledgeable person, is also in a position of conflict of interest. In these circumstances, a team of trustees and executors with different skills, abilities and interests is often the most effective.

(c) Income

When transferring the family business from new generation to the next, particularly on an inter vivos basis, it is essential to ensure that the parent and, after the parent's death, a surviving spouse, has sufficient income generated by the business, or other assets, to maintain an existing lifestyle.

This income can be generated in a number of ways. The parent can be employed in the business and receive employment income for services performed for the business. Caution should be exercised to ensure that the employment income paid for services, otherwise the business runs the risk that the payment of employment income will not be deductible to the business.

Issues of fairness between the parent and children should be dealt with in advance, particularly where the parent is significantly lessening his contribution to the operation of the business but wishes to continue receiving employment income.

Ensuring an adequate income for the parent and children who are active in the business should be resolved as part of the planning for change of control rather than being left to be dealt with if and when a conflict arises. Bonuses may be used to generate income for the parent, but caution should be exercised to ensure that the bonuses are reasonable in the circumstances, so they will be deductible to the business.

One of the most difficult things for the entrepreneur to determine when considering whether or not to do an estate freeze is whether his net worth is sufficient to ensure that he will be able to maintain an existing lifestyle. It is a problem because it is not possible to predict either rates of inflation or life expectancies with a great deal of accuracy on a case-by-case basis.

If the parent is unsure whether the assets will be sufficient to maintain an existing lifestyle, if frozen a partial estate freeze should be considered.

To effect a partial estate freeze, the parent would exchange only a portion of the existing common shares of the business for preference shares. The remaining common shares owned by the parent would continue to appreciate in value as the business increased in value. This will allow the parent to participate in a portion of the future growth in the value of the business. The disadvantage of doing a partial estate freeze is that capital gains tax will be payable on the inherent gain on the common shares retained by the parent on the parent's death.

However partial freezes can be carried out more than once as the value of the parent's estate increases. Each time a partial freeze is conducted the capital gains liability is fixed on the portion of the common shares, which are frozen at that time.