

COMMENT BACKGROUND

Number 262 – JULY / AUGUST 2010

CORPORATE ATTRIBUTION

Income Tax Act (Canada) reference:

- Section 74.4 – Transfers and loans to corporations

LONGEVITY

- 2009 Statistics Canada Population estimates and projections
- Genetic Signatures of Exceptional Longevity in Humans, Sebastiani et al, American Association for the Advancement of Science

IN WHAT COUNTRY DO I RESIDE?

Canada Revenue Agency Technical Interpretation:

- IT-221R3, Determination of an Individual's Residence Status, dated December 21, 2001

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Corporate Attribution

Income splitting strategies continue to thrive, and for very good reason – if you can successfully split income with a family member who has no other income, your family can save up to about \$12,000 in income taxes for each such family member annually.

There are many potential income splitting strategies for families. As a result, there are many anti-avoidance measures in the Income Tax Act that seek to limit or reverse this tax advantage.

For example, attribution rules treat income received by one taxpayer as income received by another taxpayer for income tax purposes. The attribution rules that relate to income splitting involving corporations can be confusing and, because of changing circumstances, can have an impact many years after a corporate structure has been put in place. One of the “sleeper” anti-avoidance measures is called the corporate attribution rule.

In general terms, the rule applies as follows:

- where an individual resident in Canada has transferred or lent property to a corporation that was not a small business corporation, and one of the main reasons was to reduce his or her income and benefit another person who is a “designated” person;
- then the individual is assessed an interest benefit based on the value of the property transferred and the current prescribed interest rate, to the extent that calculated interest benefit exceeds any interest or dividends received in respect of the property transferred.

A designated person is a spouse or common-law partner of the individual, or someone under the age of 18 who either does not deal at arm’s-length with the individual (e.g., a child), or is a niece or nephew of the individual.]

A small business corporation is a Canadian-controlled private corporation where all or substantially all of the fair market value of its assets is attributable to an active business carried on primarily in Canada. “All or substantially all” has been interpreted by the Canada Revenue Agency to mean

90% or more.

Application of the corporate attribution rule can arise very innocently and in almost any estate freeze corporate reorganization implemented for an individual. During such a reorganization, an individual taxpayer will often transfer his or her shares into a new holding company and take back fixed-value preferred shares. New common shares will be issued directly to the family (i.e. spouse and children), or indirectly to a trust on behalf of the family. One reason for an estate freeze is to create the ability to split income and multiply the capital gains exemption. However, the stage is now set for the corporate attribution rule to apply, because the individual has transferred property and one of the main reasons was to reduce income and benefit one or more “designated persons”.

It should be noted that the interest benefit assessed under the corporate attribution rule does not apply when the corporation is a small business corporation. Therefore, the simplest means of avoiding the interest benefit is to ensure the corporation meets the requirements of a small business corporation when the transaction occurs, and remains so afterwards. However, maintaining such a status can be difficult during the ownership of the active operations, and becomes increasingly difficult after the active operations have been sold. The attribution rule will apply to investment corporations, or any corporation that primarily earns passive income.

As the holding company builds up an investment portfolio from the after-tax accumulated income of the operating company, it will begin to reach the limits of the definition of a small business corporation and may eventually fail the test, which can lead to the assessment of an interest benefit to the preferred shareholder under the corporate attribution rule.

Planning involves not only the creation of structures to achieve objectives, but the constant review of structures to maintain the objectives sought. The corporate attribution rule is a sleeper rule that can arise many years after a corporate restructure.

I/R 2500.13, 1101.00

Longevity

A recent study says scientists in the United States have discovered the genetic signature of an exceptionally long life. The study indicates that with a simple DNA test it can be predicted, with 77% accuracy, which individuals are biologically built to live beyond age 100.

Canadian census data shows a marked increase in the number of individuals who are surviving to older ages. Life expectancy, or the number of years an individual is expected to live (as measured at birth), has been slowly increasing over time.

Life Expectancy at Birth		
	Age of Life Expectancy	
Year of Birth	Males	Females
1991	74.6	80.9
1996	75.5	81.2
2001	77.0	82.1
2006	78.4	83.0

As life expectancy is increasing, so too is the number of years an individual will spend in retirement. In 2009, the number of individuals aged 65 or older was 4,687,400, or 13.9% of the entire Canadian population. The 2009 figure grew by 130,572 from 2008, only one year before, when this portion of the population represented only 13.7% of the entire population. This segment and its ratio to the entire population are projected to continue to increase.

While this is exciting news for many individuals, it has many financial implications.

Longer life expectancies will have a tremendous impact on retirement and estate planning for individuals and their children:

- Longer life expectancies mean that retirement resources will have to be stretched further. If life expectancy increases, so will the number of retirement years (unless we see a trend to change the “standard”

retirement age).

- Longer life expectancies mean the next generation will not be able to depend on an inheritance to subsidize their own retirement.
- Estate plans will have to be reviewed to take into account this shift in demographics. Individuals will have to start recognizing that an aging parent could become dependent on a retired child. Reflecting a potential dependency situation in a child’s will may become more common.
- Powers of attorney should be drafted now to ensure the desired oversight of wealth and health.

Federal, provincial, and municipal governments will have to take heed of this change in demographics, since the “65 plus” cohort’s needs will tend to draw more on government services and will impact governmental budgets over many years. As well, governments will have to wrestle with the fact that the under-65 segment becomes a smaller portion of the entire population, which means the supporting tax revenue and pension contributions will be coming from a smaller group.

The financial industry is responding to this new demand with new products such as guaranteed withdrawal products, and more traditional offerings such as annuities and life insurance.

Financial planners are responding to this new situation by adding life expectancy as a new variable and mixing products to better hedge against the financial risk of longevity. Life insurance is being used to replace wealth that was eroded by the financial needs of a longer retirement.

Longevity has become the newest risk to be addressed in financial planning, and individuals are well advised to ensure that the financial risk associated with longevity has been considered in their plans.

I/R 2500.00

In What Country Do I Reside?

It sounds like a simple question, and for many taxpayers there is no issue or question. In Canada, like many jurisdictions, residency is the major criterion used to establish income tax liability. An individual who is resident in Canada will be subject to Canadian income tax on his or her worldwide income, regardless of where that income is earned or generated. While non-residents may be subject to taxation in Canada, the type of income subject to tax is much narrower.

From the taxpayer’s point of view, it may be desirable to be taxed in a country with a lower income tax liability. From Canada’s point of view, however, tax revenue is gained or lost

based on the taxpayer’s determination of residency.

The Canada Revenue Agency (CRA) has published an Interpretation Bulletin in which it sets out the criteria it uses when determining residency. The process followed by the CRA is to review a series of primary and secondary factors in establishing whether an individual has residential ties to Canada.

In order to achieve non-resident status, a taxpayer must sever all important residential ties to Canada.

The primary factors used by the CRA in determining the

issue of residency include (among other factors):

- 1) The dwelling place normally occupied by the taxpayer
- 2) Where the taxpayer's spouse or common-law partner resides
- 3) Where the taxpayer's dependents reside

The dwelling an individual has maintained in Canada will play an important role in the evaluation. If the dwelling remains available to the taxpayer for his or her use, this is often viewed as a residential tie to Canada. On the other hand, leasing out the property (at market rates and terms) so that it is not available to the taxpayer can help break the residential ties.

Similarly, if the spouse and/or dependent children remain in Canada, that could be considered maintaining a residential tie to Canada. However, the CRA would take into consideration the relationship between the parties to determine whether they were living separate and apart already before the residency determination arose.

Even if the taxpayer is successful in establishing non-residency based on the above factors, the CRA looks at a group of secondary factors on a collective basis to determine whether the taxpayer is still a resident of Canada. It would be unusual for any one single factor to determine residency status, but evidence of several factors may tip the scale in the determination.

Secondary factors include:

- 1) personal property in Canada (i.e. furniture, vehicle, etc.)
- 2) social ties with Canada
- 3) economic ties with Canada
- 4) landed immigrant status, or appropriate work permits in Canada

- 5) hospitalization and medical insurance coverage from a province or territory of Canada
- 6) driver's license from a province or territory of Canada
- 7) a vehicle registered in a province or territory of Canada
- 8) a seasonal dwelling place in Canada, or a leased dwelling place
- 9) a Canadian passport
- 10) memberships in Canadian unions or professional organizations

This list is not intended to be exhaustive but rather is representative of the type of additional items considered by the CRA when assessing the issue of residency. The cumulative presence of several secondary ties could tip the scales in favour of a determination of tax residency. The weighting given to each will depend on the CRA's judgement in any set of circumstances. For example, a summer cottage that contains personal property, and to which the taxpayer returns every summer, will be two factors. The taxpayer who wants to break tax ties with Canada may want to close all Canadian bank accounts, cancel his or her driver's license, sell any automobiles, and cancel any golf memberships, to avoid the additional accumulation of secondary factors.

In Canada, a resident is taxed on his or her worldwide income. If a taxpayer wants to establish himself or herself as a non-resident of Canada, it is very important that he or she observe how the CRA will determine residency status, and ensure that all the central factors and as many secondary factors as possible are avoided. It is also important to note that non-residents may still be subject to Canadian taxation if they were employed in Canada, carried on business in Canada, or disposed of taxable Canadian property at any time of the year or in a previous year.

I/R 7401.00

Yin and Yang

There has been no shortage of opinions as to whether a fixed or variable rate mortgage makes greater sense in the long run. Yet, the difficulty with opinions lies in the very definition: an opinion is someone's belief without positive proof. The crux of the issue is that the real answer depends on the facts associated with each individual's specific circumstances – as well as unpredictable changes in interest rates.

From the mortgage lender's perspective, qualifying an applicant for a mortgage is a process of assessing the applicant's financial ability to cover the regular mortgage payments, and the ability to recover the value of the loan in the event of default. The lender assesses the broad picture by looking at the percentage of gross annual income that would be directed toward housing expenses. Included in this

assessment are four major considerations: principal, interest, property taxes, and property insurance. There are a variety of limits as to what this percentage should be, with 28 per cent to 30 per cent being the conservative range, and 35 per cent the upper end. Each lender has guidelines as to the maximum percentage it is prepared to underwrite. Lenders also consider the borrower's total debt commitment (i.e. including all other debt payments) relative to income, with rules of thumb in the range of 34 to 40 per cent.

The process should not end here. The lender's point of view is oriented toward protecting its investment, but the homebuyer's concerns are quite different. It is crucial for individuals to assess their own financial risk tolerance, personal comfort levels, and emotional tolerance.

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Financial risk tolerance assesses one's current and projected income levels, relative to the stream of committed payments. Recent federal legislation has changed the rules, in recognition of the fact that interest rates, both fixed and variable, are expected to rise over the near term as the economy picks up. These changes mean lenders now have to consider the borrower's ability to pay not simply the mortgage payment that results if the borrower opts for the lower variable rate type of mortgage, but also the payments for this same mortgage amount under a five-year fixed rate plan. This has added a new dimension in the pure financial assessment. And wise borrowers will make sure they can handle increased borrowing costs, at least in the next few years.

However, savvy individuals need to look beyond simple financial ratios used by the lenders. Maybe one can afford the current 'principal, income, taxes and insurance' (PITI) under the lender's criteria, but what about the borrower's personal comfort "barometer"? Having a safety cushion of extra discretionary income adds comfort and stability, and the greater this surplus, the more secure an individual can feel, both in the short and longer term.

The personal comfort barometer considers economic and lifestyle issues that can impact the borrower's ability to meet financial commitments, and ultimately add or reduce stress arising from these commitments. How secure does the borrower feel about his or her ability to handle an interruption to income or changes in discretionary spending?

Income interruption: If the mortgage payment and other non-discretionary financial commitments depend heavily on a couple's combined income, consideration of potential income interruptions is important. Maternity/paternity leaves, extended illness, job loss, or an unanticipated need for a leave of absence can have a potentially devastating impact on a borrower's ability to make his or her mortgage payments. When the ratio of PITI to income is high, there is a greater risk of default and a more rapid drain on any financial savings the homeowner might have. When the ratio is lower, the borrower's ability to manage through unanticipated interruptions is better.

Discretionary lifestyle: How much of the borrower's current income is dedicated to discretionary lifestyle spending such as movies, decorating, dining out, sports, an updated vehicle, or vacations? These expenditures could change significantly with commitments to increased mortgage payments. While a bigger home may appear attractive initially, the attractiveness can quickly dissipate when a large mortgage payment becomes the ongoing reason for unanticipated changes in lifestyle. Financial stress is not limited to the inability to make a payment, but is often felt when there is a constant and ongoing lack of funds for lifestyle interests. The term 'house poor' is often used to refer to individuals whose financial commitment associated with their home leaves few if any discretionary dollars; and it must also be remembered that the bigger the home, the higher the maintenance, heating, and power costs are likely to be.

The third major consideration is emotional tolerance, which involves the feelings experienced as non-controllable factors vary. For example, if a variable mortgage has been chosen and interest rates begin to climb, how emotionally ready is the borrower to ride out the increases as the payment continues to take a larger bite out of total income? Maybe the mortgage product allows the borrower to lock in at some point, but what about the interest rate at the renewal – how well equipped is the borrower to emotionally handle upcoming increases in debt load? Spending a significant amount of time worrying about uncontrollable financial implications can take an emotional toll on individuals and their relationships.

Understanding what mortgage products are available and how the product design might fit a borrower's personal needs can be helpful when making the choice between variable or fixed rate mortgages. Financially astute individuals do not rely on lenders to determine their future; instead, they take control through self-awareness and introspective assessments. Before signing on for the long term, borrowers should take the time to do a careful assessment of financial and emotional tolerance combined with an introspective assessment of their personal comfort barometer.

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