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Newsletter

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WHEN CAN YOU USE YOUR RRSP TO BUY A BUSINESS?

Author: Mecheliena Wilson, CA, Partner, Davis Martindale Accountants

If you are purchasing shares of a privately owned corporation, you may be considering purchasing them through your Registered Retirement Savings Plan ("RRSP") to obtain a tax deduction. There are strict rules in place that dictate which investments are allowed to be held within an RRSP.

Generally, in order for shares of a privately owned corporation to be considered a qualified investment for RRSP purposes, all of the following conditions must be met:

- You and anyone related to you <u>do not</u> own, directly or indirectly, 10% or more of any class of shares of the company or a related company immediately following the purchase by the RRSP. If the ownership is 10% or more, you and/or anyone related to you do not control the corporation and do not own shares, including shares purchased by the RRSP, of the company or a related corporation having an aggregate cost of $25,000 or more.
- The corporation is controlled by Canadian residents.
- At least 90% of the assets of the corporation are used in an active business carried on in Canada. An active business generally excludes an investment or real property rental business.

Even if the investment qualifies, there are other factors you may wish to consider before deciding to invest through your RRSP. First, when the shares are disposed of and cash is returned to you, any growth in the value of the shares will be taxed at a higher rate of tax than if the shares were held as a non-RRSP investment. For example, based on current rates and assuming you are in the highest marginal tax bracket, an accrued gain of $100,000 would attract tax of approximately $46,400 if invested in an RRSP. If the shares were held outside of an RRSP, the tax would be $23,200. This is due to the full withdrawal from an RRSP being taxed versus a 50% inclusion rate for capital gains on investments held outside of an RRSP.

Secondly, shares held within an RRSP are not eligible for the $750,000 lifetime capital gains exemption. If the shares qualify at the time of disposition, the tax may be reduced to nil (subject to alternative minimum tax). This is a significant disadvantage to holding the shares through an RRSP if they would otherwise qualify for the exemption. The rules surrounding the capital gains exemption are detailed and thus are not discussed in this article.

Finally, there may be restrictions on the amount of dividends that can be paid. If any portion of a dividend is considered to represent a payment for services rendered by the annuitant, beneficiary, or subscriber of the RRSP to the corporation, the shares may cease to be qualified investments. If the shares do not qualify, their fair market value must be included in income.

If you would like more information about this topic, please consult one of our tax professionals.

Inside this issue:

"Success is simple. Do what's right, the right way, at the right time."
Arnold H. Glasow

Special points of interest:

- ***Maximum RRSP limits:***
  2009 - $21,000
  2010 - $22,000
- ***Beware of aggressive charitable donation schemes. The CRA is now reassessing "Wine Donation" receipts for the years 2000 to 2007.***
- ***Personal tax instalments:***
  - June 15, 2009
  - September 15, 2009
  - December 15, 2009

POSITIONING YOUR BUSINESS FOR SALE

Author: John Tobin, CA, CFP, Tax Partner, Kenway Mack Slusarchuk Stewart LLP

During tough economic times, it may be difficult to envision a possible sale of your business. However, it is likely an appropriate time to start positioning your business so that it will be attractive to a wider range of possible purchasers when economic conditions improve.

Matters to consider could include:

- Segregating, in a separate company, non-core business and investment assets such as: corporately held investment portfolios; each saleable business unit; life insurance; and real estate, including real estate required in the operations of the business.
- Paying owner-managers a fair market value salary and bonuses. Alternatively, separately disclose remuneration paid to owner managers. This will simplify a purchaser's efforts to determine what the normalized profits of the business are and make the valuation process more straightforward.
- Arranging to repay any shareholder loans owing to the company. Purchasers seem to consider a repayment or purchase of a shareholder loan as part of the proceeds paid for the company – possibly lowering the valuation for the shares.
- Removing excess working capital from the company. Also, if the company is under-leveraged, consider increasing bank debt and removing the excess capital. This should enhance the shareholders' value when combined with the working capital removed from the business.
- Establishing employment agreements with key employees.
- Having annual audited financial statements or, at a minimum, a review engagement report.
- Having an established management team in place that can operate the business in the absence of the owners. This will typically increase the value of the business.
- Having an appropriate management information system in place to ensure that the data generated from the system is useful and reliable.
- Adding external members to your Board of Directors. This would provide additional input into the business operations and will subject management to further discipline in reporting.
- Making sure the minute book for the company is complete and accurate.
- Making sure all filings with the Canada Revenue Agency, such as GST returns and corporate income tax returns, remain current.
- Having in place appropriate errors and omissions insurance and liability coverage.
- Not having corporate owned "executive" vehicles and golf or other memberships. Instead, pay an appropriate automobile allowance for business use and reimburse costs associated with business memberships. Costs to maintain these benefits may have a negative impact on share valuation.
- Planning a reorganization, well in advance of any possible sale, to multiply the $750,000 lifetime capital gains exemption among family members if a share sale is a possibility. A reorganization when the valuation of the company is low may be beneficial.

Making these adjustments could make your business more valuable and will certainly make the business more attractive to a wider field of potential investors.

PUBLIC MARKET MELTDOWN—IMPACT ON PRIVATE COMPANY VALUATIONS

Author: Michael Carnegie, B.Comm, CA, CBV, Partner, Taylor Leibow LLP

Most people are aware of the significant drop in the stock markets last fall. What does this imply for the values of private companies?

Private-company and public-company valuations are correlated, but not perfectly. Valuation parameters are not the same in both sectors. Much of the difference relates to future growth expectations.

Let's consider "Company A," a public company whose price-earnings ratio is 25:1. This 25:1 ratio means that for every $25 of stock price, there was $1 of earnings per share in the last year. This ratio implies that the return on investment for the stockholder is 4% ($1 is 4% of $25).

Equity investors expect a return on investment greater than 4%, as a 4% return is available on less risky investments. It follows that the market expected Company A's earnings to grow to provide a return of perhaps 8%, 10%, 12%, or more.

Let's now consider the market for private companies, in which it is very difficult to convince a purchaser to factor growth into its price. There are two reasons why this is the case:

1. **Growth Prospects** – Private businesses tend to be smaller than public companies. In such companies, the driving force of growth is often the entrepreneur. Private companies generally do not have a formal business infrastructure to drive growth.

2. **Who Gets Credit for the Growth** - The lack of separation between ownership and management in many private businesses indicates to a purchaser that growth needs an outside force to be sustained. Purchasers often say that if the business is to grow, it is a function of what they bring to the table and not factors which are inherent in the company. Therefore, a purchaser is willing to pay for what exists at present but will not acknowledge a forecast for growth.

These two factors mean that private businesses are most often valued based on historical results of operations and not future expectations.

When growth is eliminated from the value equation, the differences between public company and private company values are not eliminated but are reduced to other factors such as the higher risk associated with smaller, less diversified businesses.

Referring back to Company A, a reduction in the market's expectation for growth may move the price-earnings ratio to 17:1. The market, by lowering its growth expectations, has eliminated 32% of Company A's value. Doing so increases the implied return on investment to 5.9%, which is still lower than most prudent investors hope to achieve.

While acknowledging that other price differentiators exist, I have illustrated that if the stock market goes down by 32%, it is in part a function of lower forecasts for growth in earnings. Because growth in earnings is not usually included in the values of small- and medium-sized enterprises, the same 32% decline in value would generally not apply in the valuation of such businesses.

While business values, in general, may be down, private-company values will not move directly in step with public market values.

QUICK TAX FACTS

UNUSED CAPITAL LOSSES AND THEIR CARRY FORWARD/BACK RULES

Author: Sharat Gupta, Senior Tax Manager, Ginsberg Gluzman Fage & Levitz, LLP

We all know that economy is going through a down turn. The effect is clearly visible on the stock market. Many of us have lost money in stock market; but, there is always a positive angle to everything. The losses from the sale of shares are considered capital losses (unless the investor is a day trader). The taxable portion of the capital losses may be applied against taxable capital gains for the prior three years or carried forward to be applied against taxable capital gains in future years. The application of capital losses is subject to stop-loss rules. Capital losses do not expire and have a tax cash value for use in future years.

HOME RENOVATION TAX CREDIT

Author: Firas Nasser, CA Student, Ginsberg Gluzman Fage & Levitz, LLP

In January 2009, the Federal Government introduced the Home Renovation Tax Credit (HRTC). This entitles you to a credit of 15% of qualified expenditures over $1,000 to renovate your home from January 27, 2009 through to February 1, 2010, up to a maximum of $10,000 of expenses. The maximum credit is $1,350. It can only be claimed by one person in each household and only on personal property, not rental or commercial property. Eligible expenses include kitchen, bathroom or basement renovations; new flooring, roof, furnace or driveway; painting; fixtures; swimming pools; among many others.

MEALS AND ENTERTAINMENT FOR GST INPUT TAX CREDITS

Author: Sharat Gupta, Senior Tax Manager, Ginsberg Gluzman Fage & Levitz, LLP

Meals and entertainment are 50% deductible under section 67.1 (1) of the Income Tax Act. This limitation also applies to GST input tax credits (except for registered charities) under section 236 of the Excise Tax Act (ETA). In claiming ITC for GST purposes, only half of the ITC for meals and entertainment should be claimed. The Canada Revenue Agency is now sending reassessments, under ETA, to corporate clients based on the amount of add-back done on Schedule 1 for meals and entertainment. Clients must prove that the ITCs are already reduced in order to reverse the reassessment, which can be frustrating.

T1 ADJUSTMENTS

Author: Firas Nasser, CA Student, Ginsberg Gluzman Fage & Levitz, LLP

The Canada Revenue Agency allows you to make adjustments to your personal tax returns after they have been filed. If you have any donations slips or medical expenses that you forgot to include in your original return, or even other expenses, such as child fitness and child care, an adjustment can be made to your tax return. Furthermore, any T-slips (T4, T5, T3, T5008, T5013, etc.) that were not reported in your tax return can be reported through this adjustment. Failure to report these T-slips can cost you a penalty of up to 20% of the amount that was not reported.