Private Company Services
High Net Worth

Wealth and Tax Matters

for individuals and private companies

Autumn 2008

PRICEWATERHOUSECOOPERS

In this issue

Editorial

We're back with a second edition of *Wealth and Tax Matters*. If you missed the first one and would like a copy, please refer to the box at the bottom of the contact page.

The autumn edition begins with the announcement that Kathy Munro will be taking over the role of High Net Worth Leader from Bruce Harris. Working exclusively in estate and personal tax planning, Kathy provides sophisticated estate planning services to shareholders of private and public companies and other wealthy individuals. Kathy is a partner of our Private Company Services group and has been with the firm for over 20 years. Thank you, Bruce, for your contribution and all the best as you continue your practice in the Private Company Services group.

This edition covers a variety of topics related to personal, business and estate planning. We hope the articles will help high net worth individuals and owners of private companies meet their family, tax and business objectives. Trust basics, tax-saving strategies, ways to extract money from the business, and effective planning to reduce exposure to U.S. estate taxes are all explored. The article on scholarship programs suggests a creative way of helping groups of employees pay for tuition or school fees.

We'd like to know what you think. Send your comments and tell us more about the topics you would like covered in future editions. To do so, please contact either of us, the authors of the articles, or any of the professionals on the inside back cover. We're always happy to hear from you.

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Trust basics part 1
Removing the mystery

Trusts are a tool of the trade for many professional advisers, but they can be something of a mystery to everyone else. Each of the many types of trusts has its own characteristics and planning opportunities. Uses range from simple personal planning to complex business transactions. This article and the two that follow explain some of the key trust concepts and terminology.

What is a trust?

A valid trust is "settled" (an old legal word for "created") when a person (the settlor), showing a clear intention to create the trust, transfers a property to one or more persons (the trustees) for the benefit of other persons (the "beneficiaries"). The trustees may be individuals or institutions, and they hold the legal title of the property and are obliged to manage it for the beneficiaries, who are entitled to use and enjoy the property. The trust property and the beneficiaries (or a class of beneficiaries) must be identifiable for the trust to exist.

A trust is not a legal entity, but rather a continuing relationship between the trustees and the beneficiaries after the initial settlement. To govern the relationship, a trust document (known as an indenture) is recommended although not essential.

What are the different types of trusts?

Trusts are generally categorized as either testamentary or inter vivos. A testamentary trust is created upon the death of an individual. For example, the terms of a deceased's will could create a testamentary estate or spousal trust. An inter vivos trust is established during an individual's lifetime and can be any of a broad range of business trusts and personal trusts. Family trusts, alter ego trusts and joint spousal trusts are examples of inter vivos personal trusts.

How is a trust taxed?

Although a trust is not an entity in itself, it is treated as an individual for Canadian income tax purposes. Its worldwide income is subject to Canadian tax if the trust resides in Canada. Residence of a trust is generally determined by where the majority of the trustees reside.

The 21-year rule: Deemed dispositions for tax purposes

A trust can hold property forever, unlike an individual. To ensure that trusts eventually pay tax on capital gains on assets that they retain, Canadian tax law includes the "21-year rule."

Under this rule, every 21 years a trust is deemed to dispose of its property at fair market value and to reacquire the property at a similar amount. By distributing property to beneficiaries before that time, the trust may avoid having to pay the tax on the accrued and unrealized gain. Generally, beneficiaries who receive the assets are deemed to acquire the property at the trust's cost and will pay tax on their own gains, either when they dispose of the property or are deemed to have disposed of it on their death.

A trust is also a conduit for income, and may distribute income to the beneficiaries, which is taxed in their hands. Income not paid or payable to the beneficiaries is generally taxed in the trust. Dividends, eligible and ineligible, and taxable capital gains earned by the trust will retain their character if they are paid or made payable to the beneficiaries in the year received.

A testamentary trust is taxed at the graduated tax rates applicable to individuals, whereas an inter vivos trust is taxed at the highest marginal tax rate on every dollar of income, regardless of its level of income. For 2008, top marginal income tax rates apply to taxable income above $123,184. For details see the PricewaterhouseCoopers publication *Tax Facts and Figures: Canada 2008*, which is available in hard copy or at **www.pwc.com/ca/taxfacts**.

Furthermore, a trust is generally deemed to have disposed of its assets at fair market value every 21 years (see box). This may result in the realization of capital gains, depending on the assets the trust owns at that time.

What kind of assets can a trust hold?

For the most part, trusts can hold the same property that an individual or corporation might own, such as stock portfolios, a principal residence, income-earning properties, art and other real estate.

What is a trust used for?

A trust can be established for tax or non-tax reasons, or both. In the context of a family business, a trust is often used as a tax-planning vehicle to:

- split income among family members;
- transfer wealth from one generation to another; and
- multiply capital gains exemptions on the sale of the company's shares.

Non-tax reasons may include:

- replacing a will to preserve confidentiality;
- reducing probate fees;
- protecting assets from creditors and dependents;
- providing financial security for a specific family member;
- holding a family cottage for the next generation to enjoy;
- achieving charitable objectives; and
- diversifying an investment portfolio by going offshore.

If you are thinking of setting up a trust, read the articles that follow, which will discuss various forms of planning that use trusts.

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Trust basics part 2
Sharing wealth with family members using a family trust

The previous article outlined some of the fundamental facts about trusts and the key terminology. Here we get more specific, and consider how a trust can help to share wealth with family members.

A family trust is created for the benefit of an individual's immediate family and relatives. Typically, a grandparent settles the trust, the beneficiaries are the parents and their children, and the trustees include the parents. Family trusts are usually discretionary trusts, meaning the trustees have discretion over the distribution of income or capital among the beneficiaries.

What are the advantages of using a family trust?

Family trusts are popular vehicles for sharing wealth with family members because they offer the trustees the flexibility to accommodate the changing and competing needs of the beneficiaries. The separation of legal and beneficial ownership of properties held in the trust allows the parents to retain legal control of the properties set aside for the benefit of their children. That separation also provides some protection from claims by creditors and undesirable dependents, such as those arising from a matrimonial breakdown.

A family trust is often used for splitting income among family members. However, when income is distributed to family members who are taxed at a lower marginal tax rate, two aspects of the *Income Tax Act* must be taken into consideration: the "attribution rules" and the "kiddie tax."

In general,the attribution rules can attribute income to the settlor or to related persons who lend or transfer property to the trust if one of the main purposes may reasonably be considered to reduce their income and to benefit other individuals. The kiddie tax essentially will tax certain types of income received by a minor child (i.e., not 18 years of age in the year), at the top marginal tax rates, and therefore eliminate any tax savings.

An important benefit of the family trust is its ability to allocate future capital gains realized on the sale of qualified small business corporation (QSBC) shares. This may result in substantial tax savings by allowing more than one person to take advantage of the enhanced

Beyond the family trust

Apart from the family trust, three types of trust are commonly used for estate planning

- an alter ego trust is created for the benefit of the settlor
- a joint spousal trust is created for the benefit of both the settlor and his or her spouse
- an asset protection trust is designed to protect assets from creditors

These powerful tools will be discussed in greater detail in future articles

capital gains exemption (recently increased to $750,000) available to all individuals. On the sale of the QSBC shares, the family trust can distribute the taxable portion (i.e., 50%) of the capital gain to the beneficiaries. To the extent that a beneficiary has unused lifetime capital gains exemptions, he or she will be able to shelter the income received from the trust. The non-taxable portion of the capital gains can then either be retained in the trust or distributed tax-free to other capital beneficiaries.

For this good reason family trusts are also used for estate planning. The discussion below illustrates the use of a family trust for an estate freeze in the context of a family business.

How is an estate freeze implemented with a family trust?

An estate freeze generally refers to a transfer of wealth from one generation to another. Typically, a parent owns the common shares of his or her operating company. Over time, these shares have appreciated in value. The parent exchanges those common shares for fixed-value voting preferred shares on a tax-deferred basis. The redemption value of the preferred shares is fixed (and therefore "frozen") at the current value of the company. On the exchange, the parent may be able to trigger a capital gain to the extent of his or her unused capital gains exemption (discussed above) if the shares are QSBC shares at the time of the freeze, without creating a tax liability. As a consequence, future changes to the tax rules will not hurt the parents.

After the freeze, the family trust subscribes for a new class of common shares (i.e., the growth shares) for a nominal amount. This allows the future growth of the business to pass on to the children, while the parent retains control over the operation of the business and the distribution of profits to the children, as trustee of the family trust and through the ownership of voting preferred shares.

A parent may wish to implement a partial freeze by subscribing to some of the growth shares or by being one of the beneficiaries of the trust. The latter may trigger the reversionary trust rule in subsection 75(2) of the *Income Tax Act* if the parent also controls the trust. The following article discusses the implications of this rule, which can result in serious tax consequences to both the trust and its beneficiaries.

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Trust basics part 3

Handcuffs and no keys: Breaking simple rules can paralyze your planning

This third article on trusts is about the people in three key roles, and what they cannot do without serious estate planning and income tax consequences.

The context is the discretionary family trust. Introducing a discretionary family trust into the ownership structure of privately owned corporations can provide wonderful estate and income tax planning benefits. However, this requires that the trust be created and structured with meticulous attention to the applicable income tax rules. Even then, the subsequent behaviour of the players can do serious harm.

Sometimes PricewaterhouseCoopers is asked to review discretionary trusts that have been created by other advisers. We are constantly amazed at how many of these trusts are completely and irrevocably flawed from an income tax perspective. Equally surprising, most of the taxpayers and advisers involved lack the slightest inkling that anything was wrong. The only thing that has saved these situations from tax disaster is that the Canada Revenue Agency (CRA) has yet to see them.

One particular tax provision that seems to be consistently ignored or misunderstood creates many of the difficult tax problems. That provision is subsection 75(2) of the *Income Tax Act*. This provision restricts the activities of those in the three key roles that are essential to all trusts:

- The settlor makes a gift of property to the trust, and creates and documents the terms of the trust. Anyone who subsequently gives property to the trust could also become the settlor.
- A trustee is the person or one of the people to whom the settlor gives the settled property, and who is charged with taking care of that property for the benefit of those in the third role (the beneficiaries). The trustee is charged with the duty to take care of the property of the trust for the exclusive benefit of the named beneficiaries, and has the rights, powers and obligations in so doing that the settlor has provided for in the trust document.
- A beneficiary is the person or one of the people whom the settlor intended to benefit by setting up the trust, and making the gift of the settled property. Only the beneficiaries can benefit from the trust property.

In a pleasant departure from the norm in the *Income Tax Act*, subsection 75(2) is rather brief and is written in something approaching plain English (which doesn't seem to prevent it from being ignored). At a minimum, to avoid problems with that provision, four rules must be followed strictly:

1. The settlor cannot be, or become, a beneficiary of the trust.
2. The settlor cannot be the sole trustee, and cannot have an effective "veto" power if he or she is a trustee.
3. The settlor cannot, during his or her life, have any influence on the disposition or distribution of trust property.
4. The trust cannot acquire property from a trustee or a beneficiary, even in a fair market value purchase transaction.

Most of the problems related to subsection 75(2) result from violations of one or more of these four simple rules. The rules apply throughout the existence of the trust, so it is vital to ensure that none of them is violated after the trust is established. A person who breaks one of the rules becomes the "75(2) person" for purposes of applying the punishment — not a good thing.

So why is this provision important, and what are the negative tax ramifications of any of the four rules being violated?

First, any property income (interest, dividends, capital gains, rents, royalties, etc.) of the trust is taxable to the "75(2) person" for as long as that person is alive, rather than being taxable to the trust. If one of the anticipated benefits of the trust structure was income-splitting, violation of the rules in subsection 75(2) will prevent those benefits from being enjoyed while the 75(2) person is alive.

Second, one of the most useful features of a properly constructed trust is that the trust can "roll out" any of its property to Canadian-resident beneficiaries at any time, on a completely tax-deferred basis. This is one of the prime estate planning benefits of setting up a trust structure to pass private company shares from one generation to the next. However, these benefits can disappear suddenly. The CRA is of the view that if any of the 75(2) rules were ever violated, as long as the 75(2) person is alive, nobody else can be the recipient of a tax-deferred roll-out. Distributions to beneficiaries are still possible, but they won't be tax-deferred, defeating the whole tax-planning exercise. Further, the 75(2) person might not be a beneficiary of the trust, making it impossible for the trust to distribute the property to anyone on a tax-deferred basis.

Third, if subsection 75(2) has ever applied to the trust, there is no way to "untaint" the trust and avoid these negative tax results, other than by the death of the 75(2) person. (This sounds dangerously like a motive for murder, but we're not suggesting that.)

The CRA takes an aggressive and broad view of the interpretation of subsection 75(2), and there is little jurisprudence limiting their interpretations. This is a dangerous provision of potentially broad application. Confounding the normal rules for income tax purposes, the CRA's view is that even sales of property to the trust at fair market value, with commercial terms, creates problems for the trust if the vendor is either a trustee or a beneficiary. This trap has caught many unwary vendors.

These are the two key lessons:

1. To take advantage of the tax and estate planning benefits provided by a discretionary family trust. Competent professional tax and legal advice is essential when setting up the trust. That should include a detailed examination of the facts, with a view to avoiding the rules in subsection 75(2) and the other attribution rules in the *Income Tax Act*.
2. Even after getting everything right at the start, the settlor, as well as every trustee and beneficiary, must subsequently behave in a way that does not violate any of the four simple rules outlined above.

Attention to detail at the outset and rigorous adherence to the rules can avoid major estate planning and income tax problems that are both insoluble and expensive.

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Dividend reform
Complex but welcome

Three years ago this autumn, the federal government announced new measures to change the income tax rules related to dividends — probably one of the most significant tax reforms of the last 20 years — with major consequences for business owners and their advisers. This article provides a brief outline of the new rules which, while complex, may translate into sizeable tax savings for shareholders.

A need for change

The Canadian income tax system taxes income earned by corporations, as well as the amounts corporations distribute as dividends to individual shareholders from their after-tax earnings. To prevent double taxation, a dividend tax credit reduces the personal income tax that individuals pay on those dividends. This compensates the individuals for tax already collected at the corporate level.

Dividend reform was needed because the dividend tax credit did not take into account the variation in the tax rates applicable to different types of corporations. In Canada, corporations are usually subject to a general tax rate on their corporate income (active income). However, one type of corporation – Canadian controlled private corporations (CCPCs) – may benefit from a favourable tax rate on their business income. This is primarily due to the small business deduction, which lowers the tax rate on the first $400,000 of taxable income.

Here's the problem. Under the old dividend tax regime, for dividends from corporations that paid the full general rate, an individual's dividend tax credit was not sufficient to offset the corporate income tax that the government had already collected.

This longstanding anomaly came to a head in the early 2000s, when investors flocked to income trusts, an investment vehicle with no element of double taxation. In fact, the massive and ever-increasing popularity of income trusts forced the federal government to resolve the deficiencies of the old dividend tax credit mechanism.

New dividend tax regime: Eligible vs. non-eligible dividends

To solve the problem, the new regime had to provide tax relief for dividends that were paid from income taxed at the general rate, but not for dividends paid from income taxed at a lower rate. This led to a set of highly technical rules that distinguish between dividends entitled to a tax reduction (eligible dividends) and those that are not (non-eligible dividends).

Essentially, an eligible dividend is income distributed by Canadian corporations that has already been taxed at the general corporate income tax rate. Of course, for individuals the main advantage of receiving an eligible dividend is a higher tax credit, which reduces personal taxes. One critical (and sometimes overlooked) requirement of the new legislation is that an eligible dividend has to be formally designated by the corporation at the time the dividend is paid. This is discussed in the next article.

The benefits to an individual from receiving eligible dividends are apparent from the table, which shows the maximum 2008 personal marginal tax rates for eligible and non-eligible dividends in all provinces and territories and the differences between them. Even though the advantage varies from roughly 5% to almost 14%, the tax savings are always significant. In this case, complexity has its reward.

Top 2008 personal marginal tax rates on Canadian dividends

	Eligible %	Non-eligible %	Benefit of eligible dividend %
Alberta	16.00	26.46	10.46
British Columbia	18.47	31.58	13.11
Manitoba	23.83	37.40	13.57
New Brunswick	23.18	35.40	12.22
Newfoundland and Labrador	28.11	33.33	5.22
Northwest Territories	18.25	29.65	11.4
Nova Scotia	28.35	33.06	4.71
Nunavut	22.24	28.96	6.72
Ontario	23.96	31.34	7.38
Prince Edward Island	24.44	36.63	12.19
Quebec	29.69	36.35	6.66
Saskatchewan	20.35	30.83	10.48
Yukon	17.23	30.49	13.26

General rate income pool (GRIP)

Because CCPCs and other corporations (non-CCPCs) are taxed differently, they have to follow different rules. A CCPC must record income that was taxed at the general tax rate in an account known as the general-rate income pool (GRIP). A CCPC can pay an eligible dividend up to its year-end GRIP balance. Eligible dividends received from other corporations (whether they are CCPCs or not) must be added to the GRIP balance. Eligible dividends paid by the CCPC reduce the GRIP balance. The GRIP is a cumulative account that applies as of the 2006 taxation year.

The provisions allow for an initial adjustment of the GRIP for corporations that already existed on January 1, 2006. Generally, they can

add a portion of their taxable income that was subject to the general tax rate for the taxation years ended after 2000 and before 2006, plus any dividends received from certain related companies, to the extent they were paid from income that was taxed at the general rate. A number of anomalies regarding this initial GRIP adjustment can sometimes lead to results that appear unfair to the taxpayers involved. However, in many situations, the adjustment may provide significant benefits to business owners, because it allows the surpluses earned before the implementation of the reform to be distributed as eligible dividends.

Low-rate income pool (LRIP)

Non-CCPCs do not have to calculate GRIP and the amount of eligible dividends that they can pay is not limited. In contrast to CCPCs, non-CCPCs must record income taxed at a preferential rate (including non-eligible dividends received) in what is known as the low-rate income pool (LRIP). Income taxed at a rate lower than the general rate forms what is known as the low-rate income pool (LRIP). Non-CCPCs must clear out any amounts in their LRIP account before paying an eligible dividend by paying non-eligible dividends at least equivalent to the amount in the LRIP.

Penalties on excess dividends

Corporations that pay eligible dividends in excess of the allowed limits are subject to substantial penalties, known as Part III.1 tax. For a CCPC, this is 20% of the eligible dividend amount paid during the year that exceeds the year-end GRIP balance. Non CCPCs also pay a 20% tax, but on the lesser of the eligible dividend amount paid and their LRIP balance at the time the dividend was paid. Fortunately, if certain conditions are met, a corporation that has paid an excessive eligible dividend can make an election to prevent Part III.1 tax from being applied. The excess is then treated as an ordinary dividend for shareholders (i.e., recipients of the dividends cannot benefit from the higher tax credit on the excess portion of the dividend they received).

Other considerations

The implications of the dividend reform are far-reaching and business owners should take into account its effect on their personal and corporate planning. The analysis should start with an update of the available GRIP (or LRIP, for non-CCPCs), including the calculation of the initial adjustment and the computation of GRIP accumulated since 2006 and the estimation of GRIP to be earned during subsequent years. In addition, it should consider the consequences of the new rules on many common practices, transactions and issues, such as:

- the policy in regard to distribution of corporate profits, including salary-dividend mix, deferral of personal taxes and income splitting with family members;
- share ownership and share capital structure, with a view to optimizing the allocation of GRIP (via separate classes of common shares, use of trusts, etc.);
- approaches to sale and purchase of businesses, including sale of shares versus sale of assets, taxation of proceeds as dividend or capital gain, change of status rules, exposure to Part III.1 tax in the context of acquisition of businesses;
- corporate reorganizations and their effect on tax accounts;
- estate planning, including will planning and post-mortem strategies; and
- the advantages and disadvantages of the various elections provided by the new legislation, such as the election not to be a CCPC.

As in other areas of taxation, dividend planning is today an area in which careful thinking may result in unexpected opportunities.

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Eligible dividends
The sequel: Getting the designation process right

Here's a true story, not likely to become a major motion picture, but well worth telling.

Last April, PricewaterhouseCoopers prepared the tax returns for a business owner we will call Sam, who had always had somebody else do that job. Sam owns all the shares of a holding corporation (Samsco) that has substantial portfolio investments. Not long before, Samsco had been involved in transactions related to the sale of a subsidiary. These transactions left Samsco with a substantial general-rate income-pool (GRIP). Only out of a GRIP can a company distribute eligible dividends (refer to previous article on eligible and ineligible dividends).

While preparing the personal tax returns, we noted that Samsco had declared significant dividends at the end of 2007. We were therefore surprised to discover that the T5 tax slip Samsco had issued lacked the usual indication that the amounts received were eligible dividends. Later we confirmed that Samsco's tax professionals had not thought about the new eligible dividend notification process – an expensive oversight. Because the dividend was not properly designated by Samsco, Sam could not benefit from the low rate applicable to eligible dividends. So Sam paid $60,000 more tax than he had to, and wished he'd sought better advice sooner.

This little story highlights the fact that taxpayers, and especially their advisers, must have a basic understanding of the new rules dealing with the designation of eligible dividends. As illustrated above, even if a corporation is in a position to pay eligible dividends, the dividend will be an eligible dividend only if it is properly designated. The likely aim of the designation process is to give shareholders certainty about the implications of taxable dividends at the time of receipt.

To this end, the *Income Tax Act* has three requirements for a proper eligible dividend designation:

- the corporation must notify every beneficiary of the dividend (including non-resident and non-taxable shareholders, even if they are not eligible for the enhanced dividend tax credit);
- the notification must be in writing and is made at the same time as the payment of the eligible dividend; and
- the notification must inform the beneficiary that the dividend paid is an eligible dividend for tax purposes.

This is hardly intricate, arcane or intellectually challenging tax planning, but it is a good example of how getting the basics right can save a good chunk of money. A little more detail about the three requirements will be helpful.

Form of the designation

For the notification itself, no prescribed forms have been developed and no documents have to be filed with Canada Revenue Agency (CRA) or the provincial tax authorities. The CRA has confirmed that any of the following would be valid:

- identifying eligible dividends in a letter to the shareholders;
- a notation on the dividend cheque stubs; or
- a mention in the minutes of the corporation (if all shareholders are directors of a corporation).

In addition to the resolution declaring the dividend, it has become common practice for private corporations to prepare a separate formal notice informing shareholders of the eligible dividend designation. For public corporations, in light of the burden that the notification process could impose on entities having hundreds or thousands of shareholders, the CRA has decided to provide welcome administrative relief, and acceptable methods of making designations include posting of a notice on the corporation's website or in shareholder communications. The notice may simply state that all dividends paid are eligible dividends unless otherwise indicated.

Designation at time of payment

In addition to requiring that the designation be made at the time of payment, the rules do not allow for late designations, nor for previously issued designations to be cancelled or amended. That makes it critical that the timing of the notification be documented appropriately. In particular, the notice to the shareholder must clearly establish that it has been delivered at the same time as the dividend payment. Issuing a letter to a shareholder referring to a dividend paid earlier the same day would not likely meet the stringent requirements of the tax legislation. Also, in respect of dividend payments themselves, taxpayers and their advisors should take great care: in the event of a wrong decision, a mistake or an omission, the *Income Tax Act* does not allow retroactive correction.

Designation of the entire dividend amount

The designation must cover the whole dividend amount, except for the 2006 taxation year, for which special administrative relief applied. Accordingly, for the purpose of the eligible dividend rules, a corporation is not allowed to designate only a portion of a dividend.

Two examples illustrate the significant practical ramifications of this requirement:

- A business owner would like to receive a dividend of $150,000 from her holding corporation, which has a GRIP of $100,000. It will not be possible to declare a single dividend of $150,000 and to designate only $100,000 as being paid out of GRIP. Instead, two separate dividends will have to be declared, one a $100,000 eligible dividend, the other a $50,000 ineligible dividend.
- An operating corporation, Opco, has two shareholders, Mr. Manny Toba, a resident of Canada, and Dr. O. Verseas, a non-resident with no access to the benefits of an eligible dividend designation. Opco will not be allowed to exclude the portion of the dividend paid to Dr. O. Verseas from the eligible dividend designation. As a result, the company's GRIP will be reduced without the non-resident shareholder receiving a corresponding benefit. Fortunately, however, various techniques have been developed to direct eligible dividends to shareholders who may make use of the reduced tax rate on eligible dividends. One of these techniques is the use of different classes of shares, as described by Brendan Brode in "Sprinkling income to family members," in the previous issue of *Wealth and Tax Matters* (Spring 2008).

Other tips and traps

The rules regarding designation of dividends are relatively new, and while generally straightforward, some concerns have been identified already. In particular:

- In respect of private corporations, the CRA has expressed the view that the designation should specify the amount of the eligible dividend. As a result, dividends defined by a formula should be avoided.
- Capital dividends are dividends that can be distributed tax-free to shareholders. In some situations, following a CRA audit of the capital dividend account, the capital dividend may be converted into a taxable dividend. According to the CRA, because of the timing requirement discussed above, the deemed taxable dividend resulting from the adjustment does not qualify for the eligible dividend designation.
- A subsidiary of a public corporation does not benefit from the administrative relief discussed above, which applies only to public corporations. Consequently, any dividend paid to the parent corporation, without the required designations, will be considered a non-eligible dividend and will increase the low-rate income pool of the dividend recipient.

This article does not attempt to cover all situations that may arise under the new eligible dividend designation process. Its main purpose is simply to reiterate the need for taxpayers and professionals to become familiar with the procedural requirements. Violation of these simple technical rules may be costly for taxpayers and a source of professional liability for advisers. In that respect, under the new dividend tax regime, the payment of a dividend is no longer a routine transaction.

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Owning a U.S. vacation property

Lower U.S. property values and a strong Canadian dollar have led many Canadians to the southern United States to purchase their dream vacation properties. Many do not know that doing so exposes them to the U.S. estate tax regime.

Without planning, a Canadian's estate may be required to pay U.S. estate tax on the value of the U.S. home. Rates start at 18% and rise quickly to 45% for properties worth more than $US1.5 million. The Canada-U.S. Tax Treaty provides some relief for Canadians.

How the exemptions work

For U.S. citizens, the first $US2 million in assets are exempt from U.S. estate tax. The Treaty entitles Canadians to a percentage of that exemption, which is the proportion of value of the individual's U.S. assets to worldwide assets. For example, if U.S. property represents 20% of worldwide assets, the deceased will be entitled to an exemption of $US400,000.

The Treaty provides additional relief if the U.S. property of the deceased passes to a Canadian spouse. In general, this provision will double the exemption (calculated above) if all of the assets pass to the surviving spouse.

The U.S. annual exemption increases to $US3.5 million in 2009. However, unless new U.S. legislation is enacted, in 2011 the exemption drops to its earlier level of $US1 million and the 45% top rate reverts to 55%. Most practitioners believe that the 2009 rates and exemptions will be extended. While nothing is certain, it seems prudent to plan on the assumption that the U.S. estate tax will be around in some form beyond 2009.

Personal ownership

Personal ownership may be the simplest way to hold property if the U.S. estate tax liability can be managed or eliminated. The best approach for married individuals may be to put ownership in the hands of the spouse with the lower net worth. However, one must consider the Canadian income tax attribution rules if the spouse doesn't have his or her own source of funds to complete the purchase. Under these rules, for Canadian tax purposes the property could be considered to belong to the other spouse.

If the home is owned personally, individual wills should be reviewed. It may be possible to eliminate U.S. estate tax if the U.S. property passes to a properly structured spousal trust on death.

Personal ownership in joint tenancy

Joint tenancy is a common form of ownership for Canadians. However, joint tenancy for a U.S. property is generally not a recommended form of ownership for Canadian spouses. For U.S. estate tax purposes, the entire value of the property is included in the U.S. estate of the first spouse to die, unless the executor can prove that the surviving spouse contributed funds towards the purchase of the property. In addition, joint tenancy does not allow for any will planning to take place, because the property will pass automatically to the surviving spouse. Owning the property as tenants-in-common may be an effective alternative, because it would allow each spouse to undertake will planning to protect his or her half interest.

A Canadian trust

If the U.S. estate tax cannot be dealt with through personal ownership and will planning, consider establishing a Canadian discretionary family trust to own the property. The two key benefits are that:

- U.S. estate tax may be avoided on the death of both parties; and
- if the property is sold, any increase in value will be subject to the same capital gains rates as if the property were owned personally.

Trust ownership generally appeals to Canadians when property values exceed $US1 million and do not constitute a significant portion of the individual's net worth. This is because the individual must be willing to give up control over the property to his or her spouse and children. In addition, because of Canada's 21-year rule (see box on page 2), the trust likely will distribute the property to the capital beneficiaries before its 21st anniversary, to avoid a deemed realization of accrued gains. Therefore, the trust structure may not appeal to younger families.

Non-recourse mortgage

A non-recourse mortgage is another option, particularly if the U.S. property is already owned. A non-recourse mortgage is collectible only against the U.S. property and not against any other assets of the individual. For U.S. estate tax purposes the value of the U.S. property is reduced by the value of the non-recourse mortgage. Commercial banks may restrict their lending to 50% or 60% of the value of U.S. property and it may not be possible to eliminate the entire U.S. estate tax exposure. However, the exemptions provided under the Treaty that are discussed above may further reduce or eliminate the excess value that is subject to the U.S. estate tax.

Financing costs will have to be considered when comparing this option to other ownership arrangements. It may be possible to reduce financing costs if the mortgage interest is deductible. This means that funds from a new mortgage on the U.S. property must be used to purchase income-producing investments if the U.S. home is currently owned and mortgage-free. Consequently, current mortgage financing may have to be restructured to achieve this goal.

Other options

If personal or trust ownership does not fit the circumstances, other options should be considered. These all involve additional complexities that will require thorough review before proceeding, and include:

- ownership through a Canadian corporation;
- ownership through a Canadian partnership; and
- donation of the property to a U.S.-registered charity.

In some cases, if the U.S. estate tax exposure cannot be fully eliminated, it might be best to obtain additional life insurance. This could be the simplest solution, particularly for the young, who have access to low-cost insurance.

It is wise to consider all ownership options before entering into a purchase agreement. Many planning techniques cannot be used after the U.S. property is purchased because of the U.S. gift and income tax consequences associated with the transfer of U.S. real estate.

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Married to a U.S citizen?
Watch out for U.S. estate tax!

Standard Canadian estate and tax planning may not work for a Canadian whose spouse is a U.S. citizen or dual citizen.

If your children are U.S. residents or citizens, please refer to the first edition of *Wealth and Tax Matters* for Bryan McNulty's article on the subject.

Normally, a person who is neither a U.S. citizen nor a U.S. resident will be subject to U.S. estate tax only on assets situated in the United States, such as U.S. real estate and shares in U.S. corporations. Even these assets may escape the U.S. estate tax net if the U.S. situs assets are not significant and can be sheltered by the Treaty exemption provisions discussed on page 14.

However, having a spouse who is a U.S. citizen (even if a dual citizen) changes the picture dramatically. The U.S.-citizen spouse will be liable to pay U.S. estate tax on the fair market value of his or her worldwide assets, whether situated in the U.S. or not.

A traditional will may leave all of an individual's assets outright to the U.S.-citizen spouse. When the U.S.-citizen spouse dies, he or she will be subject to U.S. estate tax on all the assets held on death, which will include the property inherited from the deceased spouse. This could be a significant tax liability, because U.S. estate tax is charged on the fair market value of the assets, at a top rate of 45%, possibly reverting to 55% (see page 14).

U.S. estate tax is based on the fair market value of assets, including such items as insurance proceeds, so the current exemption of $2 million or even $3.5 million (effective for 2009) can be used up quickly.

For example, assume that Mr. Brown is a Canadian citizen and resident with a U.S.-citizen spouse. Upon Mr. Brown's death, his will bequeaths the following items to Mrs. Brown:

	Fair Market Value ($US)
House	$1,500,000
Investment portfolio	$2,000,000
Canadian recreational property	$500,000
Insurance proceeds	$1,000,000
Total	**$5,000,000**

Assuming Mrs. Brown owned only these assets at her death, the estate tax liability would be $1,350,000 (at 2008 tax rates), a significant proportion of the Brown family's assets.

Will planning

Spousal testamentary trusts are often used as part of a Canadian estate plan for the tax-effective transfer of assets on death. A traditional Canadian spousal testamentary trust, where assets are left in trust for the benefit of the surviving spouse, is generally not effective for U.S. estate tax purposes on the death of the surviving spouse. This is because U.S. tax law treats the surviving spouse as owning the trust assets, on account of the spouse being named as a trustee and having a degree of control over the trust assets. To effectively shelter the assets from U.S. estate tax on the surviving spouse's death, there are two options:

- A spousal testamentary trust could be established by will. The surviving spouse must not be a trustee.
- A modified spousal testamentary trust could be established, structured specifically to keep the assets exempt from U.S. estate tax. This would require that the surviving spouse's ability to participate in decisions to distribute the trust's capital be restricted.

The first option is simple, but often is not practical. In many cases a surviving spouse wants to be a trustee so that he or she can exercise some control over the trust assets.

Under the second option, the surviving spouse is made a trustee, but his or her powers are limited to an "ascertainable standard." Under this special trust, the surviving spouse is entitled to receive all income derived from the trust assets. However, his or her ability to participate in decisions to use the trust's capital is limited to situations in which it will cover expenses related to the surviving spouse's health, education, maintenance or support.

This special testamentary trust should also qualify for the Canadian "spousal rollover," so that no Canadian income tax liability should arise on the initial death of one spouse. Instead, the liability should be deferred until the surviving spouse's death.

If required, the spousal testamentary trust can be drafted to meet many other needs. For instance, a migration clause could be added to allow the trust to become a U.S. trust if the surviving spouse decides to move to the United States after the first death.

The U.S. estate tax regime may apply a hefty tax on a U.S.-citizen spouse's assets upon his or her death, which may include assets inherited from the Canadian spouse. However, an appropriate tax plan may be able to minimize or eliminate these adverse tax consequences and protect non-U.S. assets from U.S. estate tax.

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Simple cottage life (or is it?)

For many Canadian families, a cottage is a source of pleasure and can play an important and sentimental role. For those who own a cottage and plan to leave it to loved ones, or who are considering purchasing their first cottage, certain tax matters should be considered. These may influence how to pass on the cottage to heirs or how to structure the purchase.

Tax consequences arising at death

For Canadian income tax purposes, an individual is generally treated as having sold all of his or her properties at fair market value immediately before death. That can trigger capital gains taxes on the increase in value of the cottage between its purchase and the deemed disposition on death.

This capital gains tax can be postponed if the cottage is transferred to a living spouse or to a qualifying spousal trust (generally a trust established for the sole benefit of the spouse while living). In such cases, the tax can be deferred until the earlier of the disposition of the cottage by the spouse (or the spousal trust) and the death of the spouse.

The gain arising on the disposition of the cottage may be exempt from income tax if the cottage can be claimed as the individual's principal residence. However, if the individual and his or her spouse own more than one property, such as a city home and the cottage, the principal residence exemption will generally not be available on the sale of the home if it is claimed on the cottage. (Some exceptions apply if each spouse owned a property before 1982.) For individuals owning both a home and a cottage for the same length of time, the overall tax generally would be minimized by claiming the principal residence exemption on the property that has the highest gain per year that the property was owned.

Keeping the cottage in the family

Broadly speaking, three ways are available to keep the cottage in the family: bequeathing it to children in a will, transferring it to a trust or simply transferring the property outright. However, before dealing with these issues specifically it should be noted that an individual who intends to leave a cottage to the next generation should ensure that the estate will have sufficient cash to pay any capital gains taxes that may arise on death. This will prevent the cottage from having to be sold to pay the taxes. If the estate would not otherwise have sufficient liquid assets, one solution may be to purchase a permanent life insurance

policy to cover the expected tax liabilities.

A parent can leave the cottage jointly to all of the children through his or her will. However, the reality of shared ownership, such as how the children will share the use of the cottage and pay for the annual expenses and upkeep, may be problematic and can cause tension within the family. To reduce the risk of problems, parents should have open discussions with their children to determine whether the children really want the cottage.

Another option is for the parent to transfer the cottage to a family trust that is created in his or her will for the benefit of the children. The trustee could be a close family friend or a relative, who could ensure that each child receives equal opportunity to use the cottage. The will could also provide for other assets to be transferred to the trust at the same time as the cottage, to fund the annual expenses and upkeep of the cottage. However, the trust approach introduces an important wrinkle known as the 21-year rule (see box on page 2), which deems the trust to have disposed of its property every twenty-one years. This can trigger capital gains unless appropriate planning is implemented.

A transfer of the cottage to the next generation before a parent's death can make sense if the value of the cottage is expected to increase significantly during the lifetime of the owner, even if the principal residence exemption is not available. Under this plan, any future increase in the value of the cottage can be taxed in the hands of the children or can potentially be exempt from tax by using the children's principal residence exemptions. This approach may also avoid probate fees or estate administration tax in the jurisdictions that impose them.

However, the parent should consider the tax consequences of the transfer. If he or she has owned the cottage for a number of years and its value has increased, a transfer today will result in a significant tax liability unless the principal residence exemption is available, even if the cottage is given to the children for no consideration.

One variation is to sell the cottage to the children and take back a demand promissory note with deferred payments. This should permit the parent to spread the capital gains tax over a period of up to five years. This option does not eliminate the requirement to pay capital gains taxes, but does defer the taxes somewhat and limits the taxes to an amount based on the current value of the cottage rather than a potentially higher value upon the parent's death.

Once the cottage is transferred to the children, the cottage could be subject to claims by the children's creditors or could be subject to an equalization claim should any of the children divorce while owning the cottage. Transferring ownership to a discretionary family trust for the benefit of the children may minimize the risk of these claims.

Planning for the purchase of a new cottage

If an individual will be purchasing a cottage in the future, he or she could consider using a discretionary trust to acquire the cottage. If the trust is set up properly, the individual may not be subject to tax on death on any increase in the value of the cottage. Rather, this gain can be taxed in the hands of the children or can potentially be made exempt from tax by using the children's principal residence exemptions. Careful tax planning will also be required, so that tax is not triggered prematurely by the 21-year rule.

Final thoughts

Owning a cottage can be a pleasurable experience, but just like maintenance of the property, proper tax planning is a must. The owner should discuss plans with his or her family to determine their wishes and should seek proper tax planning advice to preserve the wealth within the family.

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Tax-free savings account
A good deal

To create an incentive for Canadians to increase the rate at which they save, the federal government has legislated a new savings vehicle, the Tax-Free Savings Account (TFSA). The TFSA should be another high-priority investment option, in addition to Registered Retirement Savings Plans (RRSPs) and paying down a mortgage on a principal residence.

Beginning in 2009, all individuals aged 18 and older can make an annual non-deductible contribution of up to $5,000 to a TFSA. This annual limit will be indexed to inflation. Any portion of the annual limit not used in a year can be carried forward indefinitely.

Deposits to a TFSA will not be deductible for income tax purposes, but the income earned on investments (including capital gains) within a TFSA will be exempt from income tax when earned and also when withdrawn. However, TFSAs will be subject to a special tax on income generated from non-qualified investments or from carrying on a business.

Investment options within a TFSA and penalties for non-compliance

The qualifying investment rules that specify the types of investments that can be held in a TFSA mirror those for RRSPs. In addition, TFSAs are specifically prohibited from investing in certain types of investments, including:

- loans to the TFSA holder; and
- shares or debt of a corporation, partnership or trust in which the TFSA holder or a non-arm's length person has a significant interest (generally, 10% or more).

TFSA accounts will be subject to a 50% penalty tax based on the fair market value of funds invested in prohibited or non-qualifying investments within the account.

No tax deduction is permitted for service fees relating to a TFSA, or for interest expense incurred if borrowed funds are contributed to a TFSA. Finally, excess contributions to a TFSA are subject to a 1% penalty tax, similar to excess RRSP contributions.

Common saving methods

Canadians have had several vehicles in which to save money for retirement or other future use.

Funds can simply be invested by the individual, for example in the stock market or in mutual funds. These investments give rise to annual investment income that is subject to income tax at the individual's marginal tax rates. Income invested by an individual for the benefit of his or her spouse generally is attributed to the individual, eliminating the ability to have the income taxed at the spouse's lower tax rate.

TFSA versus ordinary investments
Because investment income earned within a TFSA is not subject to income tax, savings will increase more quickly within a TFSA than for income invested personally, assuming the same pre-tax rate of return. For example, an individual who contributes $5,000 per year to a TFSA for 20 years will have approximately $45,000 more in savings than an individual who contributes the same amount to a regular savings account, the income from which is taxed annually (assuming a rate of return of 5.5% per year, and an average federal and provincial tax rate of 46% on investment income.)

TFSA versus paying down mortgage on a principle residence
Another form of investment for an individual is to pay down the mortgage on a principle residence. Although the individual is not acquiring an asset that can produce investment income or be disposed of at a profit, reducing an interest cost is a valid investment option. As well, gains generated on an individual's principal residence are not subject to tax, making home ownership a tax-effective method of saving for Canadians.

Both mortgage repayments and contributions to a TFSA are made with after-tax dollars. Because income earned in a TFSA is not subject to tax, the comparison of the potential rate of return earned in a TFSA relative to the interest rate on the mortgage (adjusted to reflect the fact that this interest must be paid with after-tax dollars) will be a key consideration when deciding between these alternative investments.

Whether an individual should use excess funds to pay down their mortgage or make another investment depends on the specific situation. In particular, the relative merits of paying down the mortgage on a principal residence versus contributing to an RRSP have been debated for a long time and the introduction of the TFSA complicates the issue.

TFSA versus contributing to an RRSP

An individual who contributes to an RRSP is entitled to deduct the amount of the contribution from income, reducing the tax payable for the year as well as the effective cost of the contribution (i.e., amount contributed less the tax savings). Investment income accumulates tax-free within the RRSP, but withdrawals are subject to tax at the taxpayer's marginal tax rate. An individual can make tax deductible contributions to a spousal RRSP, which allows for income splitting with the spouse when the funds are eventually withdrawn from the RRSP. However, the new pension-splitting rules have reduced the significance of the spousal RRSP.

Both a TFSA and an RRSP allow an individual's investment to grow tax-free as long as the funds remain in the plan. With an RRSP, the contributions are tax-deductible, reducing the upfront cost of the investment. Investment income earned in an RRSP loses its character, so that when the income is withdrawn from the RRSP, the income is taxed as ordinary income, rather than at the preferential tax rates for capital gains or dividends. Contributions to a TFSA are not deductible for income tax purposes; however, the original TFSA contributions and the related investment income is not taxed, even when the funds are withdrawn.

In addition, when an individual withdraws funds from an RRSP, the contribution room is lost, and the funds cannot be recontributed to an RRSP unless the individual generates additional RRSP contribution room. Funds withdrawn from the TFSA may be recontributed at any time.

Given the differences between an investment in an RRSP and an investment in a TFSA outlined above, the decision as to whether to invest in an RRSP or TFSA must be determined case by case. There is no one-size-fits-all solution.

Finally, a significant planning opportunity may exist for some individuals who own less than 10% of a corporation. If certain criteria are met, these individuals may be able to hold their investment in the corporation in their TFSA, exempting any dividends and capital gains from income tax when earned by the TFSA and when withdrawn by the individual.

Comparing the options

The table (to the right) compares RRSPs, TFSAs and ordinary investments.

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Comparison of RRSP, TFSA and ordinary investing

		RRSP	TFSA	Ordinary investments
Contributions tax deductible?		Yes	No	No
Investment income taxed?		No	No	Yes
Withdrawals taxed?		Yes	No	No
Maximum contribution per year		Lesser of 18% of earned income and $21,000 for 2009	$5,000 for 2009 (subsequently indexed to inflation)	No maximum
Effect of withdrawals	**On contribution room**	Once funds have been withdrawn from an RRSP, the funds cannot be recontributed unless the plan holder has generated additional contribution room	Funds withdrawn from a TFSA may be recontributed to a TFSA at any time. After a withdrawal, contribution room for the next year is increased by the amount of the withdrawal	N/A
	On income tested benefits and credits	Withdrawals increase taxable income and therefore may decrease income-tested benefits and credits, such as old age security and the age credit	No effect	N/A
Deemed disposition on death resulting in income tax		Yes — the full balance of the RRSP is subject to tax at taxpayer's marginal rates, unless the RRSP is transferred to spouse	No	Yes – accrued investment income (capital gains, interest, dividends) is subject to tax unless investments are transferred to the spouse
Transferable to spouse on death on a tax-deferred basis?		Yes	Yes	Yes
Penalty on over contributions		1% per month on excess contributions		N/A

Scholarship programs – A (tax) free ride for all ages
A non-taxable employee benefit

Private companies should revisit their approach to paying discretionary bonuses to employees in light of recent legislative changes to the taxation of scholarship income.

Legislative changes

Scholarship income has long had tax benefits. Until recently, scholarships received by a taxpayer had to be included in income only to the extent that the total amount received exceeded the taxpayer's $3,000 "scholarship exemption" for the year.

For 2006 and later taxation years, the 2006 federal budget improved the benefit, raising the scholarship exemption to an unlimited amount for taxpayers enrolled in an educational program at a "designated educational institution."

A designated educational institution generally includes a university, college, or other educational institution designated under the *Canada Student Loans Act*, or is certified by the Minister of Human Resources and Skills Development as an educational institution that furnishes or improves a person's skills in an occupation. A university outside of Canada could be included if the individual attending the university was enrolled in a course that leads to a degree and is at least thirteen weeks in duration.

The 2007 federal budget broadened enrolment eligibility to include not only "designated educational institutions" but to also encompass both elementary and secondary school educational programs, effective for 2007 and later taxation years.

Scholarship program

Most parents who pay their children's private school or post-secondary tuition fees have done so with the after-tax dollars usually from their employment remuneration. The legislative changes create a potential opportunity for corporations to alter their remuneration strategies to provide non-taxable scholarships to children of certain employees. Doing so would allow those employees to retain more of their after-tax income.

A company would use a percentage of the funds that it would otherwise have used for its discretionary bonus pool to fund a scholarship program. Similar to bonus payments, scholarship awards under the program would entitle the company to deduct the full payment. However, unlike a bonus, neither the employee nor the employee's child would be

taxed on the scholarship. Of course, the student must be enrolled in a qualifying educational program or in an elementary or secondary school educational program.

A scholarship program could make children of all employees eligible to qualify for a scholarship. On the other hand, the program could be limited to only the children of a certain level of employee (e.g., management).

In either case, the overriding criterion for awarding scholarships under the program must be the student's merit, not the employee's relationship with the employer. Otherwise, the full amount of the award normally would be considered employment income of the employee and not scholarship income of the child.

The Canada Revenue Agency (CRA) has taken the position that scholarship payments must be part of a plan to help "a certain number of children" selected on the basis of their scholastic records or other achievements. Having the selection made by a board or committee of persons not connected to the company, such as schoolteachers, increases the chances of earning CRA approval.

For post-secondary institutions the CRA requires the selection criteria to exceed the minimum entry requirements and that the program limit the number of scholarships awarded annually. Recent court decisions support the position that a minimum 70% would be regarded as sufficient for academic achievement in a post-secondary environment.

Given that the expansion of enrollment requirements to both elementary school and secondary school educational programs into legislation occurred recently, it is unclear what would constitute academic achievement in these contexts. If the CRA adapts its current position, it would likely be sufficient for a student to meet or exceed the academic or intellectual proficiency admission requirements of a private elementary or secondary school.

Conclusion

In comparison to using after-tax dollars from a bonus to pay for their children's private school or post-secondary tuition fees, employees would benefit significantly from their employer allocating a percentage of the funds it would normally set aside in its discretionary bonus pool to fund a program that would provide non-taxable scholarships for their children. However, as the nuances outlined above demonstrate, careful planning must be undertaken to ensure that a scholarship program yields the non-taxable benefit to their employees.

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Cashing in
Using an equity take-out

Many entrepreneurs have most or all of their eggs in one basket — their business. In that situation, everything depends on the success of the business. One way to diversify risk, without completely exiting the business, is an equity take-out.

An equity take-out is a way for an entrepreneur to realize a portion of the value that has already been built up in the company. This can reduce the owner's personal risk and provide cash to secure the family's financial future. In these situations, the owner continues to run the business in the medium term and can retain a controlling equity position. Closing a deal of this nature usually takes approximately three to six months to complete.

How it works

In an equity take-out, the owner would choose to sell a portion of his or her shares to a financial investor, typically a Private Equity Group (PEG). Depending on the wishes of the controlling shareholder, the equity take-out might or might not be offered to all shareholders. The amount of equity sold depends on:

- the market value of the company;
- the amount of capital the shareholders would like to take out of the business; and
- whether equity control is important to the current shareholders.

Why an equity take-out makes sense for business owners?

An equity take-out transaction has a number of benefits to the shareholders and the company. These benefits can include:

- **Liquidity** – Allows the owner to convert a portion of his or her equity interest into liquid assets (e.g., cash) and facilitates the transfer of assets to children, other family members, charities etc., while diversifying the owner's investment portfolio.
- **Upside potential** – The remaining equity interest in the company preserves upside potential.
- **Management participation** – Members of the company's senior management team can be given the opportunity to acquire equity in the company, when appropriate.
- **Synergistic opportunities** – The PEG will become a financial partner who likely has the same or similar experience in the industry and therefore could add value to the operations of the company.

Common issues

The equity take-out can be an attractive option, but some strings are attached. These include:

- **Holding period of the investment** – The PEG will typically plan to hold the investment for five to seven years, at which time they will want to realize the built-up value in the business. At that point the owner will have to consider either a full exit or repurchasing their equity position at the fair market value.
- **Return requirements** – PEGs typically require a minimum internal rate of return of 20% to 30%. The equity take-out works best in high-growth businesses for which these returns are attainable.
- **Decision-making authority** – The PEG will require board representation and veto power over certain key finance and operational issues. This dilutes the decision-making authority of the shareholders, but often improves the structure of and makes the business more professional, typically with improved governance, clearer business objectives, greater discipline and a more stable base for strategic decision-making.
- **Financial reporting requirements** – The cost of complying with requirements for regular and detailed financial information on operational and financial performance and prospects can be high, depending on the systems in place.

Conclusion and next steps

Business owners can often achieve their financial objectives through an equity take-out. In the right circumstances, this type of transaction can achieve superior financial results for both the owner and the PEG. The equity take-out is most appropriate when the business has significant inherent built-up value, professional management is in place, future growth opportunities exist that could be sponsored by the PEG and the owner contemplates a full exit in five to seven years.

The PEG will work with the owner to increase the value of the business by growing the earnings organically and/or through acquisitions. If these proceed as planned, the business will have a much greater value when the PEG is ready to realize on its investment. This is attractive, but the process can be rigorous for the business owner. Using an experienced corporate finance professional to manage this process (allowing the owner and management team to remain focused on running the business) can enhance value of the company and increase the chances for a successful outcome.

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