

Private Company Services
High Net Worth

Wealth and Tax Matters

for individuals and private companies

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See **How to get *Wealth and Tax Matters***, on page 40.

Editorial

It is spring, in spite of barbecue ads proclaiming “summer’s here” at the end of April. Spring can bring a sense of growth and vitality, perhaps restoring some of the spirit that economic tumult has dislodged. Most of all, spring is a season of dramatic transition.

Transition is a theme in this edition of *Wealth and Tax Matters*. The first two articles address succession planning (what to do after a freeze) and post-mortem planning (how to plan for the biggest transition of all). These are followed by three articles on topics related to the sale and valuation of businesses: how to prepare for a sale, how the capital gains exemption can affect a non-arm’s length sale, and how to determine the right price for a business.

Two articles discuss alternative minimum tax. Here, the transition is to a substantially different taxation regime,

which can have some unpleasant surprises, as the examples show.

The remaining articles are less directly related to transitions (it is only a theme, after all). Two types of registered savings plans—education and disability—are explained in separate articles. A third finds a silver lining in the economic cloud: reducing income tax through low-interest loans.

The two remaining articles cover some geographic territory, explaining how the participation of U.S. citizens can dramatically affect how insurance is used in tax planning, and dispelling some myths about offshore investment.

The next edition of *Wealth and Tax Matters* is scheduled for the autumn, with its own transitions and more issues to discuss. In the meantime, please feel free to contact us with comments or suggestions.



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Discretionary family trust

A user's guide



Every \$18 toaster comes with a manual. To help prevent your rather more valuable discretionary family trust structure from becoming toast, this article offers some simple rules as a basic user's guide.

Let's say you have completed an estate freeze of your corporate business interests in favour of a discretionary inter vivos trust for you and your family. You and your professional advisers took considerable care in completing the estate freeze and creating the trust. That ensured that you avoided the problems that can come from:

- income attribution rules; and
- nasty (and permanent) provisions of subsection 75(2) of the *Income Tax Act* (see Trust Basics Part 3, in the Autumn 2008 edition of *Wealth and Tax Matters*).

However, the best professional assistance in completing the estate freeze and creating the family trust can be completely undone by rather mundane acts of the trustees in subsequent years.

To keep it simple, assume that Mom and Dad have frozen their interests in a corporation in favour of a family trust, that either or both of Mom and Dad are the trustees of the trust, and their children are included as beneficiaries.

Here are some good rules:

1. **Maintain vigilance against subsection 75(2)** after the structure is in place. That devastating provision can be triggered by relatively innocuous actions of trustees and/or beneficiaries at any time. Everything they do must conform to the following guidelines:

a. **No one should put additional money or other assets in the trust, or pay the trust's expenses.** The only source of funds for the trust must be either the original settled property, or more likely, dividend flows from the corporate shares that the trust now owns. Therefore:

- If the family trust bank account has an overdraft arising from bank service charges, no one can deposit funds to the account to clear the overdraft, no matter how small the deposit might be. The only exception would be if the deposit of funds were validly documented as a loan to the trust and the loan carried normal commercial terms.

- Nobody other than the trust itself can pay for an expense of the trust. Therefore, if the tax advisers have rendered a bill (as they sometimes do, for some reason) to the trust regarding the preparation of the trust's annual tax return and the family trust bank account is insufficient, no one else should pay that bill. Again, the only exception would be for a validly documented loan with normal commercial terms.

The obvious way to avoid both these problems is to provide the necessary funds by having the trust pay a dividend on the shares it owns.

- b. **No beneficiary or trustee should ever sell property to the trust,** even at fair market value.
- c. **No beneficiary or trustee should ever purchase property from the trust,** even at fair market value.

2. The trustees must complete resolutions every year that make irrevocable allocations to the beneficiaries, and subsequently equivalent funds must be distributed to the beneficiaries or used for their exclusive benefit.

Trusts are taxable on income they receive, such as dividends received on stocks the trust owns. Fortunately, if the trustees allocate those amounts to beneficiaries, the trust can take an offsetting deduction. As a result, *inter vivos* family trusts rarely have to be taxable. However, for these allocations to properly be tax deductible either:

- **the allocations must have been paid to the beneficiaries by December 31 of the year in question;** or
- **legal documentation must be on file to prove that the allocations were irrevocably payable to the beneficiaries by December 31 of the year in question.**

As well:

- a. **No minor child can receive an allocation of dividends from the trust** in the situation of a freeze of a private corporation, or the “kiddie tax” will kick in. Only beneficiaries having at least reached the age of 18 during the year can receive these dividend allocations from related corporations.
- b. **Distributions must be real.** Mom and Dad, as trustees, must not make allocations to their children as beneficiaries, distribute the allocations to the children in cash, and then have the beneficiaries give the trust distributions back to Mom and Dad. Such a self-serving misuse of the trust structure has great potential to prompt the Canada Revenue Agency's investigation and wrath.

This is not to say that the funds distributed to the beneficiaries cannot be returned to the parents if Mom and Dad have previously lent funds to the children validly for funding various expenditures for the children. For example, if Mom and Dad have lent money to Junior to buy a car on his 18th birthday, there is no reason that the trust cannot make a distribution to Junior, which he in turns uses to repay the loan principle to Mom and Dad.

3. **Trustees should file a T3 Trust return each year**, even if the trust has no income or expense for the year. Filing of a nil return will prompt the CRA to issue a nil assessment. In practical terms this means that the CRA is unlikely to look at that year again. If absolute assurance is required, the trustees should cause a small amount of tax to be payable in the trust in any year possible, because issuance of the notice of assessment for small amounts will formally trigger the normal three-year statute barring period.

4. **Seek professional assistance whenever changes in trustees are contemplated.** According to CRA technical interpretations, changes in trustees of a family trust trigger an acquisition of control for income tax purposes if the trust owns a voting majority of a corporation.

5. **Trustees and beneficiaries must understand the effect of the “association rules” and should get professional assistance** if the trust holdings include shares of a private company, to determine if

these deeming rules trigger any tax implications. For income tax purposes, every beneficiary of a discretionary trust is deemed to own all the property the trust owns. The association rules require associated corporations to share one annual small business deduction, and these deeming rules can trigger nasty tax surprises if any beneficiary personally owns and operates a small private business company.

6. **All trustees must remember the 21-year rule**, which generally dictates that on each 21st anniversary of the formation of the trust, the trust is deemed to dispose of all capital property at then fair market value. Failure to remember this rule can trigger unpleasant financial consequences.

Rules to live by

Don't operate electrical appliances when you are in the tub (especially if your succession planning is not complete) and follow the rules in this article to prevent tax disasters from zapping your discretionary family trust. Of course, the brief guidelines in this article cannot address every possible situation, so ongoing professional assistance and guidance is recommended for every one of these sophisticated estate and tax planning structures.

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Double tax on private company shares



Death and taxes may be the only two certainties, but the list of risks is much longer. Here's one: without adequate tax planning, tax may be paid twice on the same accrued gain if an individual dies owning shares of a private company. This is a serious issue for private company shareholders and their families.

In general, an individual is deemed to have sold all of his or her assets for fair market value proceeds immediately before death. When individuals who own shares of a private company die, they realize a capital gain in respect of those shares (which we'll refer to simply as "shares"), to the extent the shares' value exceeds their adjusted cost base (the "tax cost"). An important exception is made for shares passed to a surviving spouse or to a qualifying spousal trust; in either case, tax is generally postponed until the spouse dies or disposes of the shares.

The deemed disposition of the individual's shares does not, however, increase the tax cost of the corporation's assets. Nor does it increase the paid-up capital of the shares. Therefore, as illustrated below, the same economic gain may be taxed twice without careful planning.

When is planning necessary to avoid double taxation?

Generally, post-mortem planning is necessary whenever tax is payable in respect of an individual's shares as a result of the deemed disposition on death and it is unlikely that the individual's estate or its beneficiaries will be able to sell the shares. For example, it may be difficult to sell

shares of an investment holding company that owns marketable securities, real estate or other investment-type assets to a third-party purchaser. Post-mortem planning will be necessary to avoid double taxation.

In contrast, if an individual dies owning shares of an operating company, special tax planning may not be necessary to avoid double tax, if:

- the shares can be sold to a third-party purchaser; and
- the company does not own any investment or other assets that will be distributed to the estate or its beneficiaries before the shares can be sold.

Often, however, post-mortem planning will be required when the shares of an operating company are owned through a holding company, unless it will be possible to sell the shares of the holding company.

If an individual is not the sole shareholder of an operating company, it is important to consider the terms of any shareholders' agreements. For example, if a shareholders' agreement provides that shares will be bought back by the operating company after a shareholder dies, tax planning will be essential if double taxation is to be avoided.

Example

Mrs. Cooper, a widow and a resident of Ontario, owns all of the shares of Gains Inc., a private company. At the time of her death, the shares of Gains Inc. have a tax cost and paid-up capital of nil, but a fair market value of \$10 million. Unrealized capital gains on Gains Inc.'s assets total \$5 million.

Tax Consequences

As a resident of Ontario, tax of about \$2.32 million would be payable with Mrs. Cooper's final income tax return in respect of the \$10 million gain on the shares of Gains Inc., assuming that the top marginal tax rate applies to the full gain.

The double tax problem arises because neither the tax cost of Gains Inc.'s assets nor the paid-up capital of the Gains Inc. shares is increased to reflect the fact that the accrued gain of \$10 million has been taxed in Mrs. Cooper's final income tax return. Without special tax planning, when Gains Inc. disposes of its appreciated assets and distributes its after-tax proceeds to the beneficiaries of Mrs. Cooper's estate, Gains Inc. and the beneficiaries would pay additional tax of up to 29% (about \$2.9 million). Failure to plan appropriately would be expensive: total tax of about \$5.22 million in respect of shares worth \$10 million.

Planning Opportunity

Several tax planning alternatives may be available to avoid or significantly reduce this double tax exposure. The most common plan involves winding up the private company during the first taxation year of the estate and making a tax election under the *Income Tax Act*. This plan would reduce the tax liability from \$5.22 million to about \$2.9 million—a permanent tax saving of \$2.32 million. The remaining \$2.9 million of taxes can be reduced further if, when Mrs. Cooper dies, Gains Inc. has favourable tax balances (such as capital dividend account, refundable dividend tax on hand account and general rate income pool). Even without these balances, more sophisticated planning could reduce the total tax to as low as \$2.32 million.

All factors should be taken into account in determining which plan should be used to avoid double taxation. For example, the most common post-mortem planning transaction should be ruled out if Mrs. Cooper is making significant donations in her will. Once completed, that plan eliminates the capital gain on the shares that is reported in Mrs. Cooper's final tax return. Unless Mrs. Cooper has significant sources of other income in the year of her death or in the preceding year, the donation tax credits may not be fully used and full tax will be payable on the wind-up of Gains Inc. In addition, if any beneficiaries of Mrs. Cooper's estate are U.S. citizens, the post-mortem transactions must be designed to minimize the overall Canadian and U.S. tax.

Conclusion

While the steps to mitigate double tax on private company shares are usually executed after the death of an individual, planning should not be postponed until the individual has died. Care must be taken when developing the estate plan and in implementing any post-mortem plan. Various technical requirements must be satisfied and the plan should be designed to avoid all stop-loss rules and unnecessary taxes.

In addition, certain powers should be included in the terms of an individual's will to ensure that the executors will have the authority to complete the planning transactions necessary to avoid double taxation. The most common plan must be completed by the executors within the first taxation year of the estate. Your executors should be advised of this fact if you own shares that will require the double tax planning discussed in this article. Planning will minimize the tax payable on your shares and will maximize the amount to be received by your beneficiaries.

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See How to get *Wealth and Tax Matters*, on page 40.

Valuation issues for family-owned businesses



Findings from recent PricewaterhouseCoopers' research point to the need for business owners to have a clearer understanding of valuation issues and highlight the importance of planning for the future.

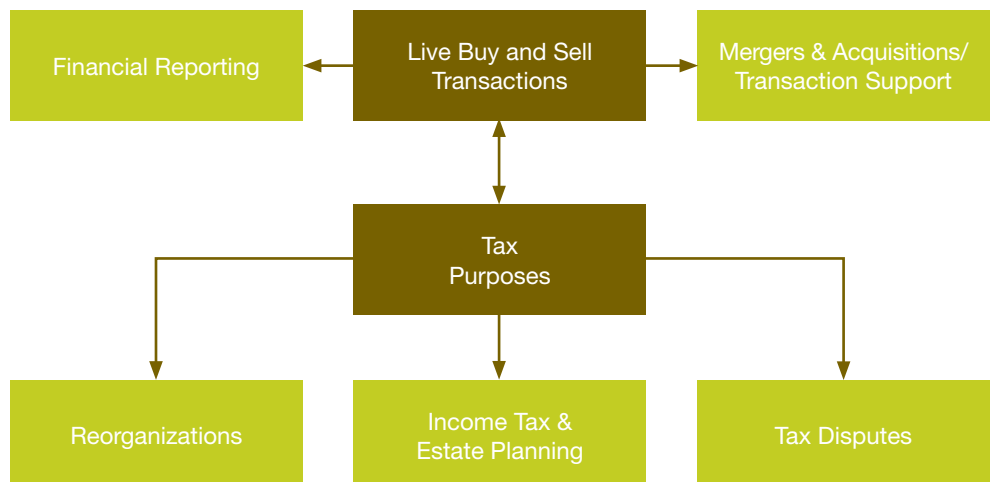
In Canada:

- 31% of family-owned businesses are planning to change hands in the next five years;
- 45% do not have a succession plan; and
- more than half of the responding companies have not been valued within the last 12 months.

The real and perceived characteristics that enhance your company's value from a buyer's perspective are the true sources of value. Generally,

your business is worth what you can negotiate for it in a sale in the open market. Alternatively, in theory within a notional (or hypothetical) market context, a business' value lies in its ability to generate cash flows in the future. As part of an overall sale planning process or in tax planning to minimize taxes, a business valuation helps to align personal, business and corporate interests. Therefore, it should be completed early in the process.

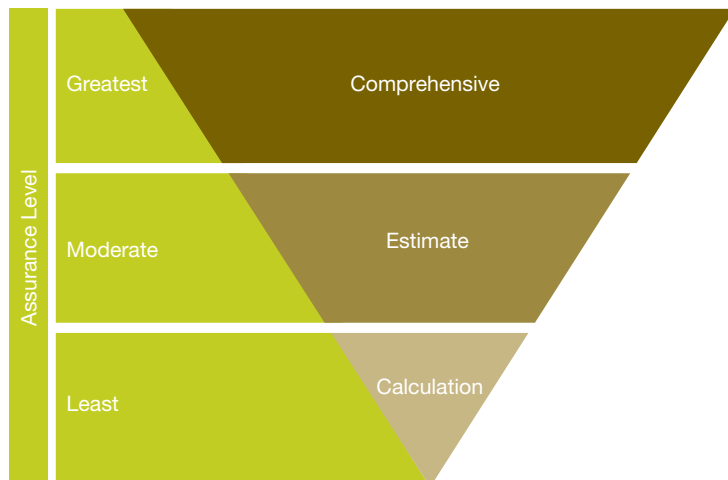
The chart below outlines a few situations that may result in a valuation requirement:



For example, in succession planning, the valuation of a business or an interest in shares is often a key factor in the establishment of transfers to family members. In situations involving a deceased owner with an interest in a private company, property passing on death may have to be valued for probate and/or income tax purposes. If you are selling a business, a professionally prepared valuation helps you determine a selling price and can add credibility to your marketing efforts.

Types of valuation reports

An independently and professionally prepared valuation helps business owners, shareholders and advisers to provide a credible, supportable and defensible value. The chart below highlights the three types of formal valuation reports a professional valuator can prepare—comprehensive, estimate and calculation:



These reports are distinguished by the valuator’s scope of review, the amount of disclosure in the report, and the level of assurance being provided in the valuation conclusion. In determining the valuation report that is required, factors the valuator would consider include the purpose of the valuation and the availability of information on which to base a conclusion. For example, in tax-related matters, an estimate level valuation is often prepared.

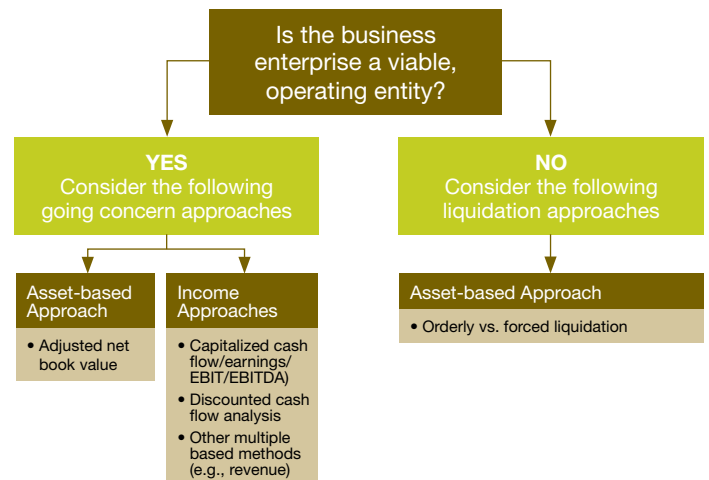
Key valuation concepts and considerations

Typically it would be unreasonable to expect a business to be exposed to the open market just to establish value for a private company. Instead, notional valuation methods are generally used to establish fair market value at a particular time. Professional valutors will investigate the market and analyze historic and projected business data. Using their professional judgment, they

provide an independent valuation to meet the needs of the interested parties.

Fair market value is defined in practice as the highest price available in an open and unrestricted market between informed, prudent parties acting at arm’s length and under no compulsion to act, expressed in terms of money or money’s worth.

The value of a business may be determined by considering one or more relevant valuation methods. When determining the appropriate valuation approach to use, one must first consider the overall outlook for the business.



In general, value is the greater of future earnings potential or underlying net asset value. Under an asset-based approach, value is determined based on the underlying assets and liabilities of the business adjusted to reflect their fair market values. The fair market value of assets may be assessed by examining net income produced, replacement cost and/or market based values. This approach is often used in the valuation of holding companies or when the business does not generate a sufficient return on its net assets.

The income-based approach relies on the general premise that the fair market value of a business is representative of the present value of all expected future economic benefits. Often inputs (e.g., earnings multiples) from a review of available market information with respect to recent sales of similar businesses and public comparable company market statistics are considered in determining value. A challenge for the valuator in this regard is the fact that truly comparable companies are often difficult to find, given factors such as differences in size, profitability, markets, products, etc., from the subject business being valued.

For example:

Using data on publicly traded companies in valuing private companies:

- Public companies often tend to be larger and more diversified, which may make them not comparable to a private company. Furthermore, the shares in public companies are more liquid and marketable than the shares in a private company, and the individual shares of public companies typically trade at a price reflecting a “minority discount” because of the inability to control the future direction of the company.

Mergers and acquisition (M&A) transaction multiples:

- Multiples implied in transactions in the same or similar industry of the subject company being valued need to be applied with caution, because the acquired companies again may not be directly comparable and/or the transactions in question may not be comparable given specific circumstances surrounding the transaction such as:
 - the sale may have occurred as a result of a forced or distressed sale, which may not be the case for the subject company being valued;
 - the market conditions at the transaction date could be significantly different from those at the valuation date; and

- the transaction price may include payment for all or some synergies, which are specific to a purchaser and may not apply to every company within the industry.

In arriving at an equity value for the shareholder(s), further adjustments are sometimes made, such as adding the value of redundant assets and deducting interest-bearing debt. In valuing a specific ownership interest in a business that is less than 50% plus one vote of the voting equity, some level of discount for lack of control or marketability will also need to be considered.

Importance of getting value correct for tax purposes

For a number of tax-related purposes, such as estate freezes, related-party transactions, corporate or partnership reorganizations, deemed dispositions at date of death and selling of a business, the Canada Revenue Agency (CRA) requires the taxpayer to demonstrate that a reasonable effort has been made to determine value. An independent formal business valuation by a qualified business valuator provides the requisite support.

The determination of value is subject to potential CRA review, so unreasonable or unsupported valuation assumptions or errors can prompt a more in-depth CRA review. This can lead to reassessment, followed by interest and penalties. As well, closer CRA scrutiny can absorb valuable taxpayer time and create additional expense. The CRA has rules to deter false statements and to ensure that valuations are reasonable, made in good faith, and are not based on unreasonable or misleading assumptions. Having a valuator who operates under these best practices and who can provide a credible, supportable and defensible value is crucial.

The best time to freeze or refreeze

As a private business owner, you may eventually want to withdraw from actively running your business. With the financial markets at their lowest level in years and the economy subdued, values for many businesses have dropped significantly. That means that there is no time like the present to consider an estate freeze and lock in the reduced fair market values. This will allow you to share the future growth with family members and

reduce your tax burden. (For more information, please refer to the articles on succession planning in the Winter 2009 edition of *Wealth and Tax Matters*, pages 20 to 27.)

Even if you have had an estate freeze, consider a “refreeze” if the value of your company has decreased significantly since then.

Professional advice

Value should be high on the agenda of every business, particularly those that are family-owned. The valuation of a business is a process that must take into account the particular aspects of each business and is often viewed as “part science, part art.” The often complex nature of operations or other considerations makes the advice of a professional essential. In Canada, the nationally recognized designation in the field of business valuation is a Chartered Business Valuator (CBV). CBVs have met the rigorous requirements of the Canadian Institute of Chartered Business Valuators (CICBV). They follow the CICBV’s Practice Standards and Code of Ethics and often work in conjunction with other professionals such as lawyers, accountants and tax specialists.

Getting professional help to assess your strategic options and advise in succession/tax planning makes sense in a rapidly evolving marketplace. An investment in securing an experienced valuation practitioner can assist in maximizing the returns of the business and avoid unexpected delays or costs in your divestiture or tax planning process.

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Grooming for success

Considerations when planning a divestiture



The current economic environment is probably not the best time to divest of holdings in private businesses. Nevertheless, preparing an exit strategy before the inevitable market recovery would be wise.

Four key planning steps you can take to reach successful deal outcomes are to:

1. clarify transaction objectives;
2. consider how a sale would affect stakeholders;
3. keep tabs on recent M&A activity; and
4. ensure that housekeeping is in order.

These planning steps are discussed below.

1. Clarify transaction objectives

For many owner/managers, determining the future of their business legacy can be challenging and wrought with emotion. However, it is critical to recognize early that a succession decision is not solely limited to selling versus not selling. While considerable time should be devoted to assessing the pros and cons of keeping the business, a host of other transaction objectives should also be considered.

Developing a clear picture of deal objectives brings focus to the process and is the first step in constructing a plan. Some possible key objectives include:

Objectives pointing to a full versus partial sale

- **Monetize some or all of the value created in the business.** While selling 100% of an enterprise generally results in the most upfront cash proceeds, selling a majority or minority stake may result in the “best of both worlds”—a large portion of value is accrued to the seller, but a retained stake ensures participation in management and future upside.
- **Remain active to ensure business continuity.** In some cases, buyers prefer that owner/managers stay on. In these cases, a seller should prepare for the post-deal dynamic of having a new partner and work out the ideal division of operational time commitment and responsibilities with the purchaser.

By identifying what percentage of the business to divest, owners can narrow the potential purchaser universe, begin the process of management succession (if required) and begin considering the other important objectives, described below.

Issues affecting deal structure

- Consideration of an optimal deal structure may seem premature during the planning stage but structure can affect the potential buyer universe and value. As well, if considered early enough, addressing these issues could allow an owner to institute tax planning measures that will maximize net proceeds.
- The most common form of divestiture is a sale of shares. However, owners can also divest all or some of the assets in their business. Which option is best depends on asset type and quality, as well as shareholders' tax positions. At a high level, a sale of shares is often preferred by vendors, because it permits use of the small business capital gains tax exemption and may limit post-deal liabilities.
- Some deals incorporate "earn-outs" or contingent consideration whereby a portion of the transaction proceeds is paid out at a later date based on the achievement of a defined milestone(s). These structures are

becoming more common as acquirers are increasingly seeking to share the risk of future performance. While the agreements are complex and require significant deliberation, as a general rule, before accepting contingent consideration, vendors should ensure they have some control over the milestone.

2. Consider how a sale would affect stakeholders

A sale's effect on key stakeholders should also be considered, because having key stakeholders in agreement is critical for a smooth and successful transaction. Some common stakeholders and issues are as follows:

Family members

- Consult with children or other family members. Identify any expectations regarding management succession to avoid management upheaval or disputes during or post-transaction.
- Determine if any non-equity family members would expect compensation or a share of sale proceeds. Keep in mind that the *Family Law Act* generally grants significant financial interests to spouses.

- Think about implementing a "family council" early on to discuss succession views and expectations.

Management team

- Consider how the existing management team might react to a change in ownership and identify any specific buyers that would or would not interact well with the existing management team.
- Given that a strong management team is viewed by some potential purchasers as a key asset, be prepared for some purchasers to require a minimum period of retention. You may wish to consider bonus payment for key management as an incentive for them to help plan and close a transaction.

Investors

- Review the shareholders agreement to determine if minority investors will be forced to participate in a sale or have rights of first refusal.
- If appropriate, discuss divestiture intentions with key investors and consider their minimum valuation or structuring expectations.

See **How to get Wealth and Tax Matters**, on page 40.

3. Keep tabs on recent M&A activity

The valuation of privately held businesses can be subjective, deriving largely from comparison against the values of other enterprises with similar characteristics—often as a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA) or another industry-appropriate metric. In some cases, specific valuation methodologies are used.

It is wise to keep a pulse on the market, even in a downturn. Having an appropriate adviser may be beneficial in providing this early insight. For a fee, or in exchange for the promise of future M&A business, advisers may be able to provide regular updates on:

- who the key buyers in a segment are;
- why buyers are active;
- what elevated or depressed value in recent transactions; and
- what the industry M&A outlook is.

Identifying the key value drivers in an industry can help owners refine operations early, thereby maximizing value upon a future exit.

4. Ensure that housekeeping is in order

A sale of a business is a complex transaction that will involve significant buyer diligence. For many owner/managers, balancing the demands of a due diligence process and the day-to-day business operations can be a challenge. However, if time is devoted preparing records for scrutiny well in advance, diligence can be less disruptive and a transaction could run much more smoothly. Here are some suggestions:

Financial information

- Engage an independent accountant to review or audit financial statements, for a three-year history or longer.
- Prepare monthly internal financial statements that clearly track major balance sheet, income statement and cash flow line items.
- Ensure that detailed accounts receivable/payable, inventory, sales, cost of goods sold and fixed asset ledgers are available and up-to-date.
- Be prepared to provide sales and profitability information segmented by customer, geography and product/service line.

- Consider paying outstanding shareholder loans, nonrecurring items or redundant assets that are unrelated to the enterprise that is for sale, because these items raise red flags, and lead buyers to reflect upon what else should be “normalized.”
- Prepare financial forecasts and budgets (typically for a minimum of three years) and ensure assumptions are clear and reasonable.
- Identify and quantify any material contingencies (unresolved litigation, future commitments, etc.).

Operational documents

- Bring key operational documents up-to-date, including:
 - organizational charts;
 - list of current employees and related salary and benefits;
 - key customer or supplier agreements and, if no agreements are in place, consider formalizing any arrangements that might be viewed as assets;
 - description of channels of distribution and, if applicable, technology architecture; and
 - business plan.

Corporate records

- Put your legal documentation in order. In particular, the following documents should be up-to-date and easily accessible;
- corporate minute books;
- share register;
- shareholder agreement (if any);
- registers of directors and officers;
- stock option agreements; and
- resolutions regarding the issuance of shares and other securities.

Material agreements and contracts

- Ensure that all key agreements and contracts are signed and up-to-date. Typical key documents include:
 - confidentiality agreements;
 - leases;
 - insurance policies;
 - loans and guarantees documents; and
 - strategic partnerships.
- If possible, limit any terms in legal agreement that would void contracts upon sale of the business.
- Ensure that the enterprise has clear ownership of intellectual property.

Key success factors

- Be prepared to demonstrate what the key value drivers of the business are. The ability to articulate an enterprise's key success factors may make the difference between an average and premium valuation. This information is highly dependent on the type of business, but can include:
 - Sales or profitability as compared to “industry benchmarks” or competitors;
 - significant barriers to entry;
 - market share;
 - sales pipeline (ideally weighted by probability of success);
 - growth prospects;
 - key business risks and risk mitigation; and
 - unique patents or intellectual property.

These steps may seem time-consuming and cumbersome. However, succession of a business often is the culmination of years or decades of work. Planning a sale well in advance can maximize value by:

- helping to identify the right potential acquirers or partners;
- making the due diligence process more efficient and effective;
- identifying a target price for the business; and
- increasing the likelihood of successfully closing a deal.

Divestiture may be the result of an unsolicited approach, or a life-long goal to capitalize on years of hard work. In either case, planning is a first step towards ensuring the success of one of the most important business transactions of a lifetime.

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Trick or Treat All year round?



On Halloween, 2006, dressed as Finance Minister, Jim Flaherty “spooked” income trust investors with a new set of tax changes. The idea was to stop the flood of conversions of profitable corporations to income trusts. Interestingly, as part of those tax changes, the Minister remedied (in part) a theoretical deficiency in the Canadian tax system that had survived since tax reform in 1971: the lack of proper integration of corporate and personal taxes on corporate income that had been taxed at the high corporate rate. He did this by introducing a new regime for personal taxation of eligible dividends.

Income trust investors felt tricked (and made their feelings known at high volume). In contrast, owners of shares of successful private businesses, and public companies, thought they could finally enjoy the “treat” of fairness regarding personal tax on the dividends (newly termed “eligible”) they received from companies that had not benefitted from the low rate of corporate tax provided by the small business deduction.

However, a trick remains for those otherwise happy investors and their eligible dividends. As Don Carson explains in his accompanying article, that trick is the alternative minimum tax (AMT). AMT was put in place to catch the fictional high-income taxpayer who escaped paying his or her fair share of tax through purchase of tax shelters and other investments with tax incentives (which, of course, were specifically added to our tax law, presumably to serve some national economic purpose).

Since its introduction, the AMT has mainly trapped unwary owners of small businesses selling business assets and/or shares—something the AMT was never meant to do. Worse, and with no theoretical justification whatsoever, it also catches people, at relatively low levels of income, who receive their income primarily as eligible dividends.

So, on one hand, Mr. Flaherty finally introduced theoretical validity to a system that had long lacked it, in that he introduced virtually perfect integration of personal and corporate taxes on both low- and high-rate corporate income, whether the dividends qualified as eligible or not. On the other hand, that perfect integration of corporate and personal tax for eligible dividends is then largely eliminated by the AMT, a provision designed (poorly) to catch and remedy an entirely different problem, which most tax professionals figure was never much of a problem to begin with.

How disappointing. While the government giveth, by applying the theoretically and economically sound concept of tax integration, it also taketh away, in this case by allowing AMT to apply even to eligible dividends—a result devoid of theoretical justification.

The next article explains the sometimes tricky workings of AMT.

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See **How to get *Wealth and Tax Matters***, on page 40.

Alternative minimum tax (AMT)

A surprise visitor



An unpleasant surprise could be in store if you are thinking of either:

- selling shares of a small business corporation or qualified farm property and using your lifetime capital gains exemption to eliminate your tax liability; or
- purchasing a tax shelter to save tax at top marginal rates.

You may find that federal and provincial minimum tax have reduced your planned tax savings.

The alternative minimum tax (AMT) was introduced effective January 1, 1986, in response to concerns that too many high-income individuals were paying little or no income tax. AMT was designed to prevent those individuals from using certain tax preferences (including deductions, credits and inclusion rates) to that end. Unfortunately, in some situations AMT applies to middle-income individuals and, as discussed below, to some taxpayers who receive income that should not be considered to be a tax preference item.

What is AMT and how does it work?

In general, the AMT operates parallel to an individual's regular income tax. Individuals (including certain trusts) must pay the higher of the two liabilities. AMT does not apply to individuals who are bankrupt or deceased.

Excluding Quebec, the provincial AMT liabilities (and possible recoveries) are generally calculated as a percentage of the federal amounts (See Figure 1). Therefore, apart from some modifications for Quebec tax purposes, the following discussion covers both federal and provincial AMT.

Under the AMT rules, various tax preference deductions, inclusion rates and credits are modified to restrict or eliminate the tax benefit otherwise granted under the regular income tax system. Common tax preferences and deductions are listed in the Appendix.

The AMT calculation

Generally, the calculation of an individual's AMT liability for the year starts with taxable income for the year for regular tax purposes. Adjustments remove certain tax preference deductions and modify inclusion rates, such as for taxable dividends, capital gains and stock option benefits. The result is "adjusted taxable income" for AMT purposes.

To exempt the majority of taxpayers who have low incomes and/or few preference items, an annual \$40,000 exemption is granted for AMT purposes for individuals and certain trusts. The income on which AMT is applied is called "net adjusted taxable income"

and is calculated by subtracting the applicable annual exemption amount from "adjusted taxable income."

The AMT is computed on the "net adjusted taxable income" at the federal tax rate of 15% (the rate for the lowest tax bracket). Most non-refundable federal credits not relating to tax preference items (including personal and spousal credits and charitable contributions) can be used to decrease an individual's minimum amount of tax. Notable exceptions to the available non-refundable federal credits are credits that are transferred from a spouse or dependant and the credit for pension income.

The minimum amount, net of the allowable non-refundable credits, is compared to the individual's basic federal tax for AMT purposes. Federal AMT is payable only if the minimum amount exceeds the basic federal tax liability.

The examples on page 18 highlight typical situations in which AMT can apply.

Figure 1: 2009 Provincial AMT Liability as a Percentage of Federal AMT Liability¹

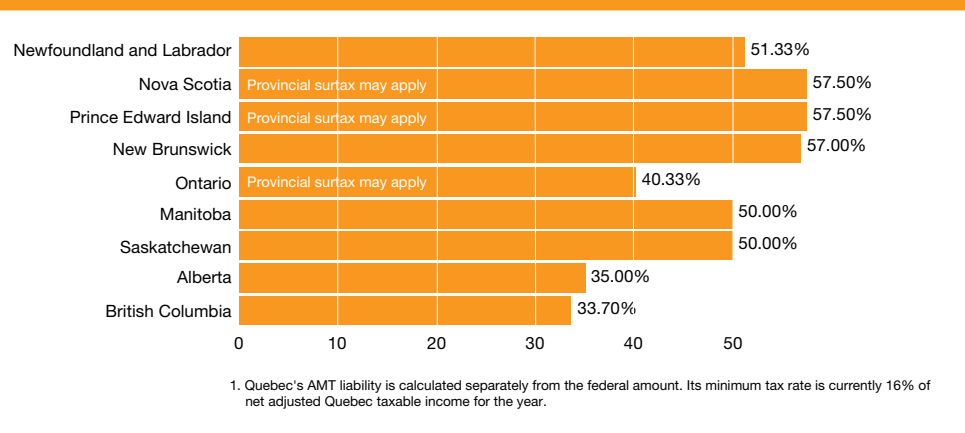


Figure 2: Examples use 2008 federal tax rates and brackets

	1		2		3		4	
	Individual with several tax preference items		Sale of qualified small business corporation (QSBC) shares		Retired investor		Leveraged investor	
Components of cash income	Regular Tax	AMT	Regular Tax	AMT	Regular Tax	AMT	Regular Tax	AMT
Employment income	\$50,000		\$100,000		n/a		\$75,000	
Pension income	24,000		n/a		\$12,000		n/a	
Interest income	19,000		n/a		10,000		n/a	
Eligible dividends from Canadian corporations (actual amount)	60,000		n/a		75,000		100,000	
Capital gains	75,000		n/a		10,000		60,000	
Capital gain realized from disposition of QSBC shares	n/a		1,000,000 ²		n/a		n/a	
Less: Investment carrying charges	n/a		n/a		n/a		(110,000)	
Income/(loss) from a limited partnership investment	(40,000)		n/a		n/a		n/a	
Carrying charges for LP investment	(25,000)		n/a		n/a		n/a	
Net cash income for the year	\$163,000		\$1,100,000		\$107,000		\$125,000	
Taxable Income								
Employment income	\$50,000		\$100,000		n/a		\$75,000	
Pension income	24,000		n/a		\$12,000		n/a	
Interest income	19,000		n/a		10,000		n/a	
Eligible dividends (with 45% gross-up)	87,000		n/a		108,750		145,000	
Taxable capital gains (50% of capital gains)	37,500		500,000		5,000		30,000	
Less: Capital gains deduction (50% of CGE)	n/a		(375,000) ²		n/a		n/a	
Income/(loss) from a limited partnership investment	(40,000)		n/a		n/a		n/a	
Carrying charges for LP investment	(25,000)		n/a		n/a		n/a	
Interest expense for investments	n/a		n/a		n/a		(110,000)	
Taxable income (for regular tax and AMT)	\$152,500	\$152,500	\$225,000	\$225,000	\$135,750	\$135,750	\$140,000	\$140,000
AMT adjustments for tax preferences								
Eligible dividends (remove 45% gross-up)		(27,000)		n/a		(33,750)		(45,000)
Taxable capital gains (create 80% inclusion rate)		22,500		300,000		3,000		18,000
Add back LP losses		40,000		n/a		n/a		n/a
Add back carrying charges for LP investment		25,000		n/a		n/a		n/a
Adjustment to capital gains deduction inclusion rate		n/a		Nil		n/a		n/a
Adjusted taxable income (from above, for regular tax)	\$152,500	\$213,000	\$225,000	\$525,000	\$135,750	\$105,000	\$140,000	\$113,000
Annual AMT exemption	n/a	(40,000)	n/a	(40,000)	n/a	(40,000)	n/a	(40,000)
Net adjusted taxable income (from above, for regular tax)	\$152,500	\$173,000	\$225,000	\$485,000	\$135,750	\$65,000	\$140,000	\$73,000
Federal tax on net adjusted taxable income								
At graduated tax rates for regular tax	A {	\$34,847	\$55,871	\$72,750	\$29,989	\$9,750	\$31,222	\$10,950
At 15% for AMT		\$25,950						
Less: Non-refundable tax credits:								
Dividend tax credit		(16,500)	n/a	n/a	(20,625)	n/a	(27,500)	n/a
Basic personal credit		(1,440)	(1,440)	(1,440) ³	(1,440)	(1,440)	(1,440)	(1,440)
CPP, EI and Canada employment credits		(567)	(567)	(460)	n/a	n/a	(567)	(567)
Pension credit		(300)	n/a	n/a	(300)	n/a	n/a	n/a
Total non-refundable tax credits	B	(18,807)	(2,007)	(1,900)	(22,365)	(1,440)	(29,507)	(2,007)
Total tax calculated	A+B	\$16,040	\$23,943	\$53,971	\$70,850	\$7,624	\$1,715	\$8,943
Minimum tax payable for year								
= Greater of regular tax and AMT								
		\$23,943	\$70,850	\$8,310	\$8,943			
Additional tax payable for year due to AMT (and AMT carry-over amount ⁴)								
= AMT - regular tax		\$7,903	\$16,879	\$686	\$7,228			

2. Assumes that taxpayer has full lifetime capital gains exemption (CGE) available to shelter capital gains realized from disposition of QSBC shares.

3. Assumes that no EI premiums are payable.

4. The AMT carry-over amount can be carried forward for up to seven years and used as a credit against future regular taxes.

Example 1:

- The main contributors to the taxpayer's AMT liability are the losses associated with the taxpayer's limited partnership investment and related carrying charges.
- To prevent having an annual AMT liability, the taxpayer could restructure his or her investment holdings and/or increase the amount of income that is subject to full tax rates (i.e., employment and interest income).

Example 2:

- The primary reason for the taxpayer's AMT liability is the lack of any adjustment to the 50% inclusion rate associated with the capital gains deduction for AMT purposes.
- Often, a taxpayer's use of the lifetime capital gains exemption is not ongoing. Therefore, any AMT liability realized in the year of the sale may be fully recoverable in the future. (See "The Carry-Over Provision" below.)

Example 3:

- The taxpayer's AMT liability stems mainly from the fact that a significant portion of the regular tax liability is sheltered by the dividend tax credit for eligible dividends. (See "Application of AMT to taxable dividends" below.)
- To prevent having an annual AMT liability, as in Example 1, the taxpayer could restructure his or her investment holdings and/or increase

income subject to full tax rates (i.e., employment and interest income). However, future changes to the taxation of eligible dividends might reduce the need to restructure the taxpayer's portfolio to eliminate AMT.

Example 4:

- As in Example 3, the taxpayer's AMT liability stems mainly from the fact that a significant portion of the regular tax liability is sheltered by the dividend tax credit for eligible dividends.
- To prevent having an annual AMT liability, the taxpayer could restructure his or her investment holdings and/or increase income subject to full tax rates (i.e., employment and interest income). However, as in Example 3, the taxpayer could restructure his or her investment holdings and/or increase income subject to full tax rates (i.e., employment and interest income).

The carry-over provision

Any minimum tax above regular taxes can be carried forward for up to seven years and be used as a credit against future regular taxes. The carryover can be used only to reduce regular taxes to the minimum amount of tax in future years. Therefore, depending on the taxpayer's future income and tax preference deductions, it might be possible to recover a portion or all of the AMT previously paid. AMT cannot

be carried back to offset regular taxes paid for previous years.

Application of AMT to taxable dividends

The concept of "integration" is a fundamental component of the Canadian income tax system. From a theoretical perspective, in respect of tax rates a Canadian-resident individual in the top tax bracket would not care whether certain types of income are earned indirectly through a taxable Canadian-resident corporation or directly if the after-tax proceeds were the same. For the indirect income, the analysis must take into account:

- combined net taxes (i.e., aggregate federal and provincial corporate income taxes paid, less any applicable dividend refund) paid corporately; and
- combined federal and provincial income taxes paid on the distribution of all of the corporation's net income as dividends.

The Canadian tax mechanism for achieving integration includes the gross-up of dividends received by a Canadian-resident individual (to currently 145% of the amount actually received for eligible dividends and 125% of the amount actually received for non-eligible dividends) and the use of non-refundable tax credits. Unfortunately, this applies only to

regular tax, and not to AMT. Instead, the actual amount (i.e., 100%) of the dividends is subject to federal tax at a rate of 15%, with no credit offered to compensate for the underlying tax being paid at the corporate level.

The result of this asymmetry is that AMT can apply to individuals who receive a significant portion of their income as dividends. The fairly recent introduction of the system for the treatment of eligible dividends has substantially increased the possibility of AMT for taxpayers in all income classes. As a result, to avoid AMT from permanently applying to them, many taxpayers might have to restructure their holdings. However, future changes to the taxation of eligible dividends (through reductions to the dividend gross-up and related tax credit) should reduce the application of AMT to future eligible dividend receipts.

Ways to reduce and/or avoid AMT:

Ways for taxpayers to reduce exposure to AMT include:

- reducing use of tax preference deductions;
- for owner-managers, receiving employment income instead of taxable dividends (because employment income will be taxed for regular tax purposes at higher rates than dividend income);
- reducing the use of certain tax reserves and accelerating the taxation of income; and
- if capital gains do not qualify for a capital gains deduction, triggering offsetting capital losses before the end of the taxation year.

The government's view

According to the federal Department of Finance in its *Tax Expenditures and Evaluations Report for the Year 2000*, the AMT system was “introduced to prevent high-income individuals from using one or more tax incentives to pay little or no tax in any given year. However, it was also important that existing tax incentives put in place for valid economic and social reasons not be undermined by the minimum tax.” Therefore, a balancing act was, and continues to be, necessary.

The Department of Finance concluded that “the AMT has contributed to the reduction in the proportion of high-income non-taxable returns at a relatively minor cost to the public. In addition, after making some minor changes since its introduction, the structure of the tax does not undermine the policy objectives behind the various preferences and reinforces tax fairness.”

Overall conclusion

Planning to avoid or reduce exposure to a future AMT helps taxpayers to preserve valuable cash flows. In addition, strategies are also available for taxpayers to convert previously-paid AMT liabilities into current tax savings. Your PwC tax adviser can help you assess your options.

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Figure 3: List of Tax Preferences and Deductions

Tax Preferences	Included in AMT Base?	Remarks
Before Total Income:		
Losses due to CCA and carrying charges on rental and leasing property	Yes	This tax shelter has been closed since 1994.
Losses from limited partnerships or tax-shelter partnerships	Yes	Some of these deductions were related to those above.
Deductible amounts with respect to tax shelters	Yes	
Carrying charges related to limited partnership, or partnership that owns rental, leasing or film property	Yes	
Non-taxable portion of capital gains	Yes	Currently an 80% inclusion rate exists for AMT purposes. Does not include non-taxable portion of gains resulting from foreclosures, conditional sales repossessions, gains exempt under a tax treaty, and gains on certain gifts and donations.
Exemption of scholarship income	No	
Other exempt income (e.g., capital dividends)	No	
Before Net Income:		
RPPs and RRSPs	No	Effective 1994 tax year.
RESPs	No	
Union dues	No	
Child care expenses	No	
Attendant care expenses	No	
Allowable business investment loss	No	100% deductible rather than 75% deductible.
Moving expenses	No	
Support payments	No	
Carrying charges and interest expenses	Yes	Only for investments relating to tax shelters, limited partnerships, resource property, certified film property or rental and leasing property.
Exploration and development expenses	Yes	Only to the extent that carrying charges and depletion allowances and other expenditures create a loss.
Other employment expenses	No	
Meals and entertainment expenses	No	
Before Taxable Income:		
Employee home relocation loans	Yes	
Stock option and shares deduction	Yes	
Limited partnership losses of other years	Yes	Only losses from CCA and carrying charges on multiple-unit residential buildings, film property, rental and leasing property, and resource expenditures and depletion allowances.
Non-capital losses of other years	Yes	See above.
Net capital losses of other years	No	Net non-deducted losses from previous years are subtracted from the AMT base.
Lifetime capital gains deduction	No	
Northern residents deduction	No	
Additional deductions	No	
Non-Refundable Credits:		
Personal non-refundable credits	No	
CPP/EI contributions	No	
Pension income	Yes	
Caregiver amount	No	
Disability amount	No	
Disability amount transferred from dependant other than spouse	Yes	
Interest on student loans	No	
Tuition and education amounts	No	
Tuition and education transferred from child	Yes	
Amounts transferred from spouse	Yes	
Medical expenses	No	
Charitable contributions credit	No	
Other Credits:		
Dividend tax credit	Yes	Dividends are included at their cash value.
Foreign tax credit	No	Modified version is used for AMT purposes.
Logging tax credit	Yes	
Overseas tax credit	Yes	
Political contribution tax credit	Yes	
Labour-sponsored funds credit	Yes	
Investment tax credit	Yes	Non-refundable portion only.

Source: Department of Finance

Insurance and U.S. citizens

Watch out for U.S. estate tax!



As part of the estate planning process, individuals in Canada often purchase insurance to help fund tax liabilities arising on death. In addition, some insurance products are purchased as an investment vehicle to shelter income from tax.

Planning with insurance is effective in Canada because, generally speaking, insurance proceeds are received tax-free. However, for U.S. citizens living in Canada, great care is required to prevent those proceeds from being subject to U.S. estate and income tax. Planning is required if the U.S. citizen is the potential purchaser of the policy or will be the ultimate beneficiary of the policy.

Owning an insurance policy

A U.S. citizen is subject to U.S. estate tax on the fair market value of his or her worldwide assets. Currently, the first \$3.5 million is excluded from tax. Any amount over \$3.5 million will be subject to tax at a top rate of 45%.

A U.S. citizen that owns an insurance policy on his or her life and dies owning the policy will be required to include the entire amount of the proceeds received on death in the worldwide estate for U.S. estate tax purposes. This is the case whether or not the estate is the beneficiary of the policy. Therefore, even if the U.S. citizen's other worldwide assets are less than the \$3.5 million estate tax exemption, the insurance could push the value over the limit, creating exposure to U.S. estate tax.

A U.S. citizen will be required to include all insurance policies in which he or she

is the insured and has any "incidents of ownership" in the policy. Incidents of ownership include the right to:

- change beneficiaries or their shares;
- surrender policy for cash or to cancel it;
- borrow against the policy reserve; or
- pledge the policy as collateral.

As a result, employer-held insurance likely has to be included in the value of the worldwide estate, because they give the U.S. citizen the ability to name and change beneficiaries.

What to Do?

If the U.S. citizen is married to a non-U.S. citizen, one way to avoid the application of U.S. estate tax is to have the spouse own the policy on the U.S. citizen's life. Care must be taken in drafting the spouse's will to ensure the U.S. citizen would not obtain incidents of ownership over the policy if the spouse were to predecease the U.S.-citizen spouse.

A U.S. citizen who already owns the insurance policy could decide to allow the policy to lapse and have the spouse purchase new insurance. If this option is not cost-effective, the insurance could be transferred to the spouse. However,

the U.S. citizen must survive for three years after the transfer to prevent the insurance from being included in their estate for U.S. estate tax purposes. In addition, it is important to ensure that the transfer of the policy will not result in the U.S. citizen's being subject to U.S. gift tax on the transfer. Currently, a U.S. citizen can make annual transfers to a non-U.S. citizen spouse of \$133,000 without triggering U.S. gift tax. The value of the gift of the insurance will depend largely on the type of policy (e.g., term policy, universal policy).

Another option for dealing with the insurance policy is to create a Canadian-resident irrevocable life insurance trust (ILIT) to hold the insurance policy. The ILIT would hold the policy for the benefit of the beneficiaries, who are generally the same as those named in the U.S. citizen's will. Ideally, the insurance premiums would be funded by the ILIT through contributions received from a non-U.S. citizen. However, if the U.S. citizen must fund the policy, tax advice is essential to avoid the application of U.S. gift tax.

Corporate-held insurance

In Canada, when dealing with estate planning involving a family-owned or private business, insurance is often held by a company, because a corporation normally has more after-tax dollars for making premium payments. In addition, payment of insurance proceeds out of the company on the shareholder's death to the shareholder's estate has tax benefits. However, if the shareholder is a U.S. citizen, this typical Canadian estate

planning could result in harsh U.S. estate and income tax consequences, such as the following:

- If the U.S.-citizen shareholder controls the company owning the insurance, the full value of the insurance proceeds will form part of his or her estate for U.S. estate tax purposes.
- Even if the U.S.-citizen shareholder does not control the company, the value of his or her shares in the company will increase as a result of the value of the insurance proceeds received. That increased value of the shares is included in the U.S. citizen's U.S. estate tax calculation.
- Generally speaking, for Canadian tax purposes, insurance proceeds are paid out of a corporation as a tax-free capital dividend to its shareholder(s). However, if the insurance proceeds are paid out to a U.S.-citizen shareholder or to a spousal trust and the spouse is a U.S. citizen, the proceeds likely will be subject to U.S. income tax. This is because the U.S. does not recognize the Canadian concept of a tax-free capital dividend account. This issue often arises with joint last-to-die policies held in a corporation when one of the insured shareholders is a U.S. citizen.

Clearly, tax advice should be obtained when insurance is purchased in the corporate context when there is a U.S. citizen shareholder, a shareholder is married to a U.S. citizen or the shareholder has children who are either U.S. citizens or U.S. residents.

Married to a U.S.-citizen spouse

As discussed in the Winter 2009 edition of *Wealth and Tax Matters*, property held by a non-U.S. citizen could be exposed to U.S. estate tax if it is bequeathed to a U.S.-citizen spouse. Insurance proceeds often are designated outright to the insured's spouse. A spouse who is a U.S. citizen will be subject to U.S. estate tax on all the assets held on his or her death, which can include the insurance proceeds.

In the Winter 2009, edition, we outlined how to provide for the U.S.-citizen spouse's inheritance through a special spouse trust rather than outright, thereby eliminating future U.S. estate tax payable. This approach should be considered when dealing with a significant life insurance policy.

Conclusion

Insurance can be an effective tool for Canadian estate planning purposes, because its proceeds are received tax free. However, under many circumstances, U.S. citizens living in Canada may have to include the value of the insurance for the purposes of determining their U.S. estate tax liability. To take advantage of approaches that allow a U.S. citizen to use life insurance in his or her estate plan without negative U.S. estate and income tax consequences, careful tax planning must be undertaken. It is also important that current insurance policies not be transferred before receiving tax advice regarding the U.S. tax implications.

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Investing offshore

Demystifying the myths



People often tell me of someone that they know or met who has a plan that allows them to avoid paying Canadian tax by directing funds to an offshore tax haven country. My typical response is: “If it sounds too good to be true, it is.” This is not to suggest that their friend or acquaintance is intentionally being untruthful, but that the person is either misinformed about the nature of the investment or plan, or how it works.

Fundamental points to keep in mind

Three fundamental points must be kept in mind when considering any possible plan that purports to avoid Canadian tax in some offshore investment or account.

First, Canadian residents are subject to tax on their worldwide income. Income from a deposit or investment, no matter where it is located (such as a bank account in the U.S., U.K. or Cayman Islands) is subject to Canadian tax. Just because the foreign country or institution does not issue a T5 or similar information slip does not mean that the income need not be reported in a Canadian tax return.

However, to avoid double taxation, Canada typically allows a tax credit for the foreign tax paid on that income. Some investments, discussed in more detail below, may also trigger deemed income if the investment does not generate actual income.

Second, if a foreign corporation:

- has a Canadian shareholder; and
- is controlled by that Canadian (or his or her family or any unrelated group of up to four Canadians),

their share of any investment income that corporation earns is subject to Canadian income tax. It doesn't matter if the corporation distributes the income to them.

For example, a Canadian-resident individual who owns a Cayman-resident corporation must pay Canadian income tax on any investment income the corporation earns. If tax is incurred in the foreign jurisdiction on the income, to avoid double taxation the Canadian system will reduce the amount of Canadian tax incurred. These rules are not intended to increase the amount of tax paid by the Canadian but to

eliminate the ability of the Canadian to defer or eliminate Canadian tax. Accordingly, if an amount is included in a Canadian's income because of these rules, the taxpayer can claim a deduction when the corporation actually distributes the income.

Third, a Canadian who invests in a foreign corporation or other entity that is not controlled by Canadians, such as a Cayman-resident mutual fund, can be deemed to have received a prescribed amount of income from that fund annually. Proposed amendments expand the scope of these rules. The prescribed annual amount is not intended to create double taxation but to eliminate the deferral of Canadian tax. Therefore, the current rules and the proposed amendments both allow a deduction when income is distributed and consequently included in the Canadian taxpayer's income.

Special rules deal with funds that a Canadian contributed to a foreign trust. Proposed amendments to these rules are under review by the Canadian authorities. If enacted in their current form, they will significantly expand the scope of the rules. In particular, the proposed rules can apply to many common transactions that are not intended to avoid or defer Canadian tax. Any offshore structure that includes

a trust that is not resident in Canada can be deemed to be resident in Canada for Canadian tax purpose, making it subject to tax in Canada on its worldwide income. Even if the foreign trust is not deemed resident in Canada, any Canadian beneficiaries may be deemed to have received income for Canadian tax purposes in respect of their interest in the trust. These rules, unlike those noted above, can result in double taxation.

All of these rules are intended to ensure that Canadian residents pay tax on their worldwide income, whether earned in Canada or not. However, the rules for offshore investments are directed at Canadians earning "investment income" outside Canada.

The lone general exception to Canada's tax policy of taxing income earned offshore is with respect to business income earned outside of Canada by a corporation. For example, if a Canadian resident (individual or corporation) incorporates a company to conduct business in a foreign country, the income the corporation earns will not be subject to Canadian tax until:

- it is distributed to the shareholder; or
- the shareholder disposes of shares of that corporation.

The Canadian tax system is a "voluntary" tax system. However, to improve compliance for offshore investments, a number of special reporting requirements apply. If the required forms are not filed by a taxpayer who has offshore investments, significant penalties can be assessed—in addition to the tax that should have been paid. Other more severe penalties punish failure to report income properly.

So, the next time that someone mentions some offshore scheme that defers or avoids Canadian tax, listen with interest. A few structures really do defer or avoid Canadian tax and are in accordance with the Canadian tax system, but these exceptions are rare, particularly for investment income earned outside Canada on funds transferred or invested by a Canadian resident. Because of the complexity of the rules, professional advice is essential before implementing any offshore plan that purports to earn investment-type income offshore.

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See [How to get *Wealth and Tax Matters*](#), on page 40.

Capital gains exemption and family business succession

Not as easy as you'd think...



A key consideration for a person selling a business is to structure the transaction so as to pay as little tax as possible. Tax planning to minimize tax will depend on how the company is to be sold—by selling either assets or shares. When shares of private corporations are sold, one key aspect to consider is the possibility of structuring the transaction so the seller can use the capital gains exemption for the sale of qualified small business corporation (QSBC) shares. In fact, if the seller meets all the capital gains exemption conditions, up to \$750,000 in capital gains from the sale of the shares will be exempt.

The purchaser will want to finance the transaction at the lowest cost possible. Thus, while enabling the seller to benefit from the capital gains exemption, the purchaser will prefer to finance the transaction with corporate after-tax money rather than funds that have been taxed at the personal level. In this respect, one might think that this type of mutually equitable

planning is open to all. Unfortunately, the Department of Finance has decided otherwise. For transactions with a related party, such as the sale of shares in the family corporation by a father to a holding corporation controlled by his child, special rules may lead to entirely different tax consequences, as shown in the following two examples:

Example 1: Converging interests, soft negotiations

Bill would like to purchase OPCO shares held by Dave. Bill and Dave are not related and are at arm's length. Following the negotiations, Dave is prepared to sell all his OPCO shares to Bill in exchange for \$750,000. The OPCO shares qualify as QSBC shares. Dave had initially purchased these shares directly from the company for \$100. Because the purchase of the OPCO shares will be financed by a loan, Bill has two options:

- Bill can personally purchase the OPCO shares and repay the bank loan over the following years with taxable dividends from OPCO. Section A shows that Bill will need taxable dividends of more than \$1,178,318 to repay the bank loan.

or

- Bill can incorporate a holding company (or use an existing holding company) that would proceed with the purchase of the shares—the objective being to enable the company to repay the bank loan with tax-free OPCO intercorporate dividends. Section B shows that given the deductibility of intercorporate dividends, total dividends of \$750,000 in this scenario will enable Bill to repay the bank loan. (For simplicity's sake, we are omitting the technical considerations for maximizing the deduction of interest, which in many situations may require the amalgamation of the holding company and OPCO.)

As shown in Sections A and B of the table, it is far less costly for Bill to conduct the transaction through a holding company than on a personal basis. Dave will not care how Bill purchases the shares, because he will be able to claim the capital gains exemption in either scenario. This use of corporate funds by a purchaser, when combined with the fact that the vendor qualifies for the \$750,000 exemption, often makes a business easier to sell.

Example 2: Opposing interests, difficult transaction

The facts in this example are similar to those in Example 1, except that the purchaser of the OPCO shares in C is Alisa, Dave's daughter, and in Section D, Holdco, a holding company controlled by Alisa.

As shown in Section C, the funds required for Alisa to purchase the OPCO shares on a personal basis are the same as those required by Bill in Example 1. Similarly, Section D shows that, from the purchaser's standpoint, a purchase by a holding company has the same benefits for the purchaser as in Section B. Unfortunately, as Section D

also reveals, if Dave completes the transaction with Alisa's holding company, the proceeds available after the sale will be significantly reduced. This is because under certain conditions, when an individual sells shares to a related corporation, the gain generated by the transaction is deemed a taxable dividend. As a result, the seller cannot benefit from the capital gains exemption and must pay the tax calculated at the rate that applies to dividends instead.

In this particular case, Dave will have to pay \$272,588 in tax on the dividend deemed received, which leaves him with after-tax proceeds of \$477,412. Of course, this result is avoided if Alisa personally acquires Dave's shares;

	Example 1				Example 2			
	A		B		C		D	
	Personal		Using OPCO Funds		Personal		Using OPCO Funds	
	Bill	Dave	Holding company	Dave	Alisa (Dave's daughter)	Dave	Holding company (controlled by Alisa)	Dave
Payment of taxable dividends by OPCO	\$1,178,318	-	\$750,000 ³	-	\$1,178,318	-	\$750,000 ³	-
Dividend tax (36.35%)¹	(\$428,318)	-	-	-	(\$428,318)	-	-	-
Selling price	(\$750,000)	\$750,000	(\$750,000)	\$750,000	(\$750,000)	\$750,000	(\$750,000)	\$750,000
Tax	-	-	-	-	-	-	-	(\$272,588) ¹
Net proceeds	-	\$750,000²	-	\$750,000²	-	\$750,000²	-	\$477,412
Cost for the buyer	\$1,178,318	-	\$750,000	-	\$1,178,318	-	\$750,000	-

1. The example uses the top 2009 marginal tax rate for ineligible dividends of a Quebec resident in 2009.

2. Dave benefits from his capital gains exemption.

3. This dividend generally would be deductible in the calculation of the holding company's taxable income.

however, Alisa must then agree to assume the increased costs related to such operations as shown in Section C.

The deemed dividend treatment described above is a direct consequence of the application of an anti-avoidance rule in the *Income Tax Act*. The underlying objective of the Department of Finance in developing this rule was to prevent the withdrawal of a corporation's taxable surplus funds (e.g., dividends) under the guise of capital gains eligible for exemption. Due to its extremely broad wording, this measure also extends to actual transactions between an individual and a corporation controlled by another member of the family, even though those transactions are essentially motivated by succession planning objectives rather than tax avoidance considerations.

Although the need for this rule can be justified in its original context, as the tax community has pointed out to the Department of Finance on numerous occasions, it is arguably unfair to extend this anti-avoidance rule to actual sale-purchase transactions between related parties, such as a father and a corporation controlled by one of his children. Nevertheless, the Department of Finance has repeatedly refused to amend the tax rules in this regard. To this day a sale to a holding company controlled by another family member generally cuts off access to the \$750,000 capital gains exemption.

This anti-avoidance rule has been in effect for almost 25 years, and the many court judgments on its application is proof of its complexity and how misunderstood it is by some taxpayers and their advisers. For example:

- In **Bisson vs. Leblanc** (2001) R.R.A. 420, the tax adviser had suggested that the taxpayer transfer the operating company's shares to his son's holding company in exchange for a demand note, while specifying that he would be entitled to the capital gains exemption. The tax authorities issued notices of reassessment and Mr. Bisson had to pay taxes and related interest on a deemed dividend. Mr. Bisson then decided to sue his tax adviser and won.
- In **Juliar vs. Canada** (2000) D.T.C. 6589, the taxpayers were more fortunate and benefitted from the leniency of the court, because the judge concluded that the application of the anti-avoidance rule was the result of the wrong information being provided to their new accountant. The professional had recommended that his clients transfer the shares they held in their operating company to their holding company in exchange for shares and demand notes. The facts established that the intention of the parties was to conduct a tax-free transaction and that if the accountant had received the proper information, the transaction would have been

structured in such a way that the anti-avoidance rule would not apply. On that basis, the court accepted the application for rectification brought by the parties.

Clearly, a business owner who wants to retire in the context of a business succession process involving family members must be well informed and consult competent advisers. Transactions between related parties, including capital gains exemption planning, are subject to special rules. Although some of the tax planning strategies described above are not available to related parties, the upside is that tax laws provide other mechanisms that when properly used can accommodate the transfer of businesses between generations. Careful implementation of those strategies can help a business owner benefit from a well-earned retirement.

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The ABCs of RESPs



The ever-increasing cost of pursuing a post-secondary education makes registered education savings plans (RESPs) particularly attractive. In addition to being a valuable tax-deferred savings vehicle, an RESP may also allow you to take advantage of government grants offered to Canadian children.

The basics

An RESP is a tax-assisted savings vehicle for funding an individual's post-secondary education. Although used mainly by Canadians to save for a child's future education, an RESP can be opened for anyone who will pursue higher education. You can even open one for yourself.

The key persons involved in establishing an RESP are:

- **the subscriber:** the person who opens the RESP and contributes to it. A subscriber can be any age and can be the subscriber of more than one RESP. Spouses or common-law partners can act as joint subscribers. A person must have a social insurance number (SIN) in order to open an RESP.

- **the beneficiary:** the person for whom the RESP contributions are being made and who will pursue post-secondary education. At the time of designation, the beneficiary must have a SIN and must be resident in Canada. Contributions can only be made to an RESP on behalf of Canadian-resident beneficiaries.

There is no limit to the number of RESPs under which a person can be a beneficiary; however, the total contributions made for the benefit of that person are subject to his or her lifetime contribution limit, as discussed below.

The three types of RESPs are outlined in the following table:

	Beneficiaries	Observations	Promoter	Investment decisions
Individual plans	Only one individual	The most common type	Offered by a wide range of institutions (e.g., financial institutions, life insurance companies, mutual fund companies, non-profit trusts)	Generally can be made by subscriber
Family plans	Can be more than one beneficiary	All beneficiaries must be related ¹ to the subscriber(s)		
Group plans	For the children of many different families	Income is pooled for use only by those children who pursue post secondary education	Offered only by group plan dealers	Cannot be made by subscriber

While there are important differences in the contribution and withdrawal rules that apply to the different types of RESPs, the remainder of this article will focus only on the individual plan. Additional information on all types of RESPs and their particular rules can be found in our recent [Tax Memo, “Understanding RESPs”](#) at www.pwc.com/ca/taxmemo.

RESP contributions

A beneficiary can receive the benefit of a maximum of \$50,000 in total RESP contributions over his or her lifetime (whether through one or multiple RESPs) and a subscriber has 31 years from the date the RESP is established to make contributions.²

RESP contributions in excess of the beneficiary’s \$50,000 lifetime contribution limit are subject to a 1% per-month tax on the over-contribution that is not withdrawn from the plan before the end of the month. This tax is levied on the subscriber of the plan. If there are multiple subscribers, the tax is levied pro rata, based on each subscriber’s share of the over-contribution.

Contributions to an RESP can be used to purchase investments to be held within the plan and the investment income earned in an RESP remains tax-deferred until the funds are withdrawn (as discussed below). An RESP’s investments are not subject to foreign property limitations and are generally limited to those that can be held in an RRSP.

Neither RESP contributions nor interest paid on funds borrowed to make RESP contributions is tax-deductible.

Canada Education Savings Grants

In addition to the RESP contributions made by the subscriber, an RESP for a child beneficiary who is resident in Canada may be eligible to receive contributions from the federal government in the form of Canada Education Savings Grants (CESGs).³ Subject to the limitations discussed below, CESG contributions will equal 20% of the subscriber contributions made.

1. For RESP purposes, a subscriber is related to a beneficiary if connected by blood or adoption (i.e., you are related to your children, grandchildren, brothers and sisters, but not your spouse or common-law partner, niece, nephew, aunt, or uncle).

2. Increased from 25 years, starting 2008.

3. Low-income families could also be eligible to receive Canada Learning Bonds.

Eligibility for a CESG contribution in a given year, and the amount of the CESG contribution, depend on:

- the beneficiary’s age;
- the beneficiary’s total family income;
- the subscriber contributions made in that year; and
- the cumulative CESG contributions received (in some circumstances).

Annual and lifetime CESG contributions that may be paid in respect of a beneficiary are limited, and additional requirements must be met for beneficiaries aged 16 and 17.

The total annual and lifetime CESG contributions available for a beneficiary from a high-income family (i.e., family net income greater than \$75,769) are set out below. CESG contribution room not used in previous years can be carried forward. This carry-forward of unused CESG room will automatically accumulate for every year from the

child’s birth, regardless of whether an RESP had been established for that child at that time.

Subscriber contributions in excess of what is needed to receive the maximum CESG contribution for that year do not earn CESG contributions in later years (i.e., the subscriber contributions cannot be carried forward); making a one-time RESP contribution of \$50,000 would result only in a lifetime CESG of \$500 to the beneficiary of a high income family (or \$1,000 if CESG room has been carried forward). Therefore, while maximizing RESP contributions early on would likely optimize the income that could accumulate tax-deferred in the RESP, the benefits of doing so should be weighed against the potential loss of CESG contributions.

CESG contributions can be paid to an RESP only up to December 31 of the year in which the beneficiary turns 17 years old.

Maximum annual CESG room per beneficiary (20% x \$2,500 ⁴)	\$ 500
Maximum CESG contribution in a year (if CESG room is available) (20% x \$5,000)	\$1,000
Maximum lifetime CESG per beneficiary	\$ 7,200

4. \$2,500 is an annual cap on RESP contributions that can receive CESG when no CESG carry-forward room is available.

RESP withdrawals

While held in the RESP, income earned on contributions is not subject to tax. The eventual tax consequences of withdrawing funds are set out below.

tax of 20%.⁸ The regular tax can be deferred and the penalty tax can be avoided if the AIP is transferred to the subscriber's RRSP or to a spousal RRSP, up to a maximum of \$50,000 in AIPs transferred (or \$100,000 if

- the withdrawal of all funds from the plan; and
- the end of the year that is the plan's 35th anniversary.

Beneficiary enrolled in QPSEP at time of RESP withdrawal?		No	Yes
Source of funds	Subscriber contributions	Can be withdrawn tax-free	
	Investment income	If can be withdrawn, constitute AIPs which are taxable to the subscriber at his or her marginal rate, plus an additional 20% tax if not transferred to an RRSP.	Constitute EAPs which are used to fund a beneficiary's post-secondary educational costs. EAPs are taxable to the beneficiary at his or her marginal tax rate.
	CESGs	If not transferrable to a sibling, ⁵ CESGs must be returned to the government.	

Additional considerations

In addition to RESPs, various other options are available to fund the cost of a post-secondary education:

- lifelong learning plan;
- tax-free savings account;
- student loans; and
- trusts.

Alberta and Quebec provide RESP-related programs that can offer additional incentives, through the Alberta Centennial Education Savings Plan and the Quebec Education Savings Incentive.

Income and CESG contributions can be paid only to beneficiaries enrolled in a qualifying post-secondary educational program (QPSEP)⁶ and are referred to as educational assistance payments (EAPs).⁷ In limited circumstances, income (but not CESGs) can be paid to the subscriber as "accumulated income payments" (AIPs) if the beneficiary does not pursue post-secondary education.

As noted in the table above, AIPs are subject to the subscriber's marginal tax rate plus an additional penalty

the subscriber is a joint subscriber to the RESP with his or her spouse). To make this transfer, the subscriber must have sufficient RRSP room and other conditions must be met.

Termination of an RESP

Once an AIP has been paid, the RESP must be terminated by February 28 of the year after the year of the first AIP payment. Otherwise, an RESP will generally terminate on the earlier of:

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5. However, no beneficiary can receive EAPs that include more than \$7,200 in total CESGs. Any excess CESGs received must be returned to the government.
 6. QPSEPs include apprenticeships, programs offered by a trade school, CEGEP (a post-secondary education institution exclusive to Quebec), and college or university. Both full-time and part-time programs must meet criteria regarding the number of hours in the program and the duration of the program in order to qualify.
 7. Certain limits apply to EAPs paid in the first 13 weeks of an educational program.
 8. The federal penalty tax is 12% for Quebec residents because Quebec imposes its own 8% penalty tax.

Registered Disability Savings Plans

Helping persons with disabilities save for their future



Disability tax credit—Requirements

To qualify for the disability tax credit, an individual must have severe and prolonged physical or mental impairments that markedly restrict the ability to perform one or more of the basic activities of daily living all or substantially all of the time (for example, seeing, speaking, feeding, walking). A qualified medical practitioner must certify the disability. Eligible individuals should apply to the Canada Revenue Agency using Form T2201.

To help save for the long-term financial security of persons with disabilities, the federal government has introduced a new savings vehicle, the Registered Disability Savings Plan (RDSP). For persons with disabilities and their families, an RDSP should be considered as a tax-effective investment option.

An individual who is eligible to claim the disability tax credit, or his or her parent or other legal representative, can establish an RDSP for the eligible individual. Only one RDSP can be established for each individual — referred to here as the RDSP beneficiary. The RDSP beneficiary must be a Canadian resident when the plan is established and when contributions are made to the plan.

Anyone can make a contribution to an RDSP, but only until the end of the year in which the RDSP beneficiary turns 59. Contributions can be made to an RDSP in respect of the RDSP beneficiary to a \$200,000 lifetime maximum, with no annual limit. The government will supplement the plan by providing incentive payments (see “Government incentive payments” on next page.)

The key tax features of the RDSP are:

- contributions to an RDSP are not deductible, and cannot be returned to the contributor;
- contributions are returned to the RDSP beneficiary tax-free;
- investment income earned in an RDSP will accrue tax-free while the funds remain in the RDSP; and
- investment income and government incentive contributions will be taxable to the RDSP beneficiary only when distributed to the RDSP beneficiary.

Investment options

The rules that specify the types of investments that can be held inside an RDSP generally mirror those for Registered Retirement Savings Plans. The RDSP holder (i.e., the individual who establishes an RDSP) will be subject to a significant penalty tax if RDSP funds are invested in non-qualifying investments and any income earned from these investments would also be taxable as ordinary income to the RDSP.

Government incentive payments

RDSP contributions made each year will generate a Canada Disability Savings Grant (“grant”). The amount depends on the family’s income, as outlined in the Table. In addition, the RDSP may be eligible for an additional payment in the form of the Canada Disability Savings Bond (“bond”). Grant and bond payments are contributed to an RDSP as shown below.

Receipt of grants and bonds does not reduce the lifetime maximum RDSP contribution limit of \$200,000.

Planning contributions

Planning is required to optimize the tax deferral on investment income earned from contributions to an RDSP and to maximize the lifetime grant paid to an RDSP. For example, a one-time

lifetime contribution of \$200,000 to a plan will result in only one grant of either \$3,500 or \$1,000, depending on net family income. Furthermore, the timing of RDSP contributions should take into account that grants will be higher when net family income is under \$77,664 (to be indexed for inflation). It may be possible to optimize grants if contributions are made after the beneficiary’s 18th year, because at

Canada Disability Savings Grants and Bonds				
	Grants		Bonds	
	≤ \$77,664	> \$77,664	≤ \$21,816	Between \$21,816 and \$38,832
Net family income¹				
Matching rates on RDSP contributions	300% on first \$500 200% on next \$1,000	100% on first \$1,000	No RDSP contributions required	
Annual RDSP contribution qualifying for maximum	\$1,500	\$1,000		
Annual maximum incentive	\$3,500	\$1,000	\$1,000	Up to \$1,000
Lifetime limit	\$70,000		\$20,000	
Can be earned up to:	End of the beneficiary’s 49th year			

1. Net family income thresholds are indexed. Amounts shown are for 2009. For both grants and bonds, net family income is that of two years previous to the payments. For example, 2007 net family income determines eligibility for 2009 payments. When the beneficiary turns 19, net family income will be the income of the beneficiary and of his or her spouse or common-law partner.

that time net family income is based on the income of the beneficiary and of his or her spouse or common-law partner.

Withdrawing funds from an RDSP and repayment of grants and bonds on early withdrawals

Disability assistance payments are payments from an RDSP to the beneficiary and comprise contributions, grants, bonds and investment income. The portion of the disability assistance payment not relating to contributions will be taxable to the beneficiary. The RDSP must begin to make annual disability assistance payments by the end of the beneficiary's 60th year (subject to a maximum annual limit, which will be determined by the beneficiary's life expectancy and the fair market value of the plan property).

Disability assistance payments can generally be made at any time. However, because the purpose of the RDSP is to encourage long-term savings for persons with disabilities, grants and bonds received in the 10-year period before a disability assistance payment must be repaid to the government.

Example

An RDSP beneficiary will withdraw \$12,000 from their RDSP. The RDSP has assets valued at \$75,000, including \$25,000 of grants and bonds of which \$15,000 was received within 10 years of the withdrawal.

Result

The \$12,000 withdrawal will require \$15,000 of grants and bonds to be repaid to the government.

Death or cessation of disability

If the RDSP beneficiary ceases to be eligible for the disability tax credit or dies, funds remaining in the plan (net of certain grant and bond repayment requirements) must be paid to the RDSP beneficiary or to the beneficiary's estate. That amount (net of contributions) will be included in taxable income.

Treatment of RDSP for means-tested benefits

RDSP payments will not be taken into account for the purpose of calculating income-tested benefits delivered through the federal income tax system, nor will they affect Old Age Security or Employment Insurance benefits. Further, most provinces and territories

have exempted the RDSP assets and income when determining eligibility for provincial or territorial disability benefits; Quebec, New Brunswick and Prince Edward Island have partial exemptions and Nunavut has not announced its position.

Conclusion

Families and other caregivers of individuals with disabilities will find the RDSP a tax-effective option to help provide financial security for their loved ones. We understand that the RDSP is already offered at some financial institutions and will be available at more by the end of 2009.

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See **How to get Wealth and Tax Matters**, on page 40.

Opportunity Knocks

How to use low interest rates to reduce taxes



You might be able to lower your income tax through the use of low-rate interest-bearing loans. These loans allow you to split income (legally) with a lower-income spouse or child. The low prescribed rate of 1% makes this the ideal time to use this approach—one of the few benefits of the current financial turmoil.

Income-splitting has been around for years. The concept is extremely simple: move income from an individual with higher marginal income tax rate to a spouse or child with a lower rate and a separate set of personal credits. The family as a whole ends up with more after-tax dollars for the family.

But beware. The attribution rules are a key complicating factor.

The attribution rules are designed to prevent families from inappropriately splitting income through gifts or loans when the lower-income family member has neither earned the capital nor paid for its use. When the rules apply, the income earned by a person will be subject to tax in the hands of the person from whom the funds were received.

The table indicates when attribution will occur. A common example is when the higher-income spouse provides funds to the other spouse via a gift or low-interest or interest-free loan. Any income or gain from those funds or from assets purchased with the funds is taxable in the hands of the higher-income spouse, even though the income or gain belongs to the lower-income spouse.

As the table shows, similar rules apply to minor children, except that capital gains derived from funds provided as a gift are not attributed. Attribution can even apply when low- or no-interest loans are made to adult children.

Attribution basics

		Type of income			
		Interest	Dividends	Capital gains	
No- or low-interest loan	To spouse	Attributed			
	To a child (any age)				
Gift	To spouse	Not attributed			
	To a child				Minor
					Adult
Prescribed-rate loan	To spouse	Not attributed			
	To a child (any age)				

An important exception to the attribution rules for the “prescribed-rate loan” at the bottom of the table provides the basis of the strategy outlined in this article. The rules provide that attribution will not apply to “commercial” loans or “loans for value,” on which:

- interest is charged at a rate equal or greater than the prescribed rate at the time the loan was made; and
- the interest for the year is actually paid no later than 30 days after the end of the year.

The prescribed rate is set quarterly, based on the rates for certain Government of Canada Treasury Bills. These rates are particularly low, and the prescribed rate is currently set at 1% per year for loans made before July 1, 2009—the lowest rate in at least 25 years. Many investments can currently earn a virtually guaranteed return of more than 1%, so this is an ideal time to lend funds to a lower-income spouse or child to split income and reduce the family’s overall tax burden.

Consider the following example:

Rita is the higher-income spouse. Her income is taxed in the highest marginal tax rate, say 45%. Rita’s spouse, Michael, stays at home with their son David, who is 10 years old. Neither Michael nor David earns any income.

Rita has \$500,000 in a high-interest bank account that earns 3%. On the \$15,000 per year Rita earns on this investment, she pays \$6,750 income tax.

If Rita were to loan this amount to Michael at the prescribed rate of 1%, she would pay tax of \$2,250 on the interest income of \$5,000 paid to her by Michael. Because Michael is using the borrowed money for the purpose of earning income, he can deduct the interest expense from the investment income earned on the investment, so only \$10,000 (\$15,000 - \$5,000) is included in his income. Michael earns no other income and at that level will pay no income tax. However, Michael’s income reduces Rita’s spousal credit, so, in effect the result of the reduced credit is that Rita pays about \$2,500 of taxes on Michael’s net income of \$10,000.

For the family, the net tax benefit would be \$2,000 in year one alone (\$6,750 - \$2,250 - \$2,500). If this loan remains in place for 10 years with similar returns, the savings become \$20,000. These savings are further compounded if Michael re-invests his interest income or the returns on the investment increases.

If the same arrangement is made with David, the savings are even greater. His income does not reduce any of Rita's credits, so the tax benefit to the family is \$4,500 in year one. Over the eight-year period before David turns 18 years old and perhaps goes off to university, the family will have saved over \$36,000 in income taxes and David would have earned over \$80,000. This could be used to pay expenses for his benefit or fund his own university education.

To be effective, the arrangement must be set up properly and maintained diligently. The lower-income spouse or child must have sufficient cash on hand each year to be able to pay the interest on time. In some cases it may be necessary to withdraw from the investment to pay the interest before January 30 of each year. If the interest payment is missed, even by a single day in only one year, attribution will apply for the year and all subsequent years.

Low interest rates open a window of opportunity for using the economic downturn to your advantage. Even if rates go up in subsequent quarters and years, once the loan has been put into place the interest rate that must be charged and paid on loan will not. Given that the current 1% prescribed rate is exceptionally low, you may even want to consider repaying the current loans you may have in place to be able to take advantage of the newer rate. However, that may not be as simple as you think; simply modifying an existing loan is not effective, and you may have to liquidate the current investments to repay the loan.

The idea is simple. Getting it right is not, so be sure to get advice from tax professional before doing anything. Opportunity knocks! Why not reduce your family's taxes while you can?

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the 1990s, the number of people in the UK who are employed in the public sector has increased from 10.5 million to 12.5 million, and the number of people in the public sector who are employed in health care has increased from 2.5 million to 3.5 million (Department of Health 2000).

There are a number of reasons for the increase in the number of people employed in the public sector. One reason is that the public sector has become a more important part of the economy. Another reason is that the public sector has become a more attractive place to work. A third reason is that the public sector has become a more important part of the welfare state.

The increase in the number of people employed in the public sector has led to a number of changes in the way that the public sector is organized. One change is that the public sector has become more decentralized. Another change is that the public sector has become more market-oriented. A third change is that the public sector has become more customer-oriented.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is funded. One change is that the public sector has become more dependent on government funding. Another change is that the public sector has become more dependent on private funding. A third change is that the public sector has become more dependent on user fees.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is managed. One change is that the public sector has become more professionalized. Another change is that the public sector has become more bureaucratic. A third change is that the public sector has become more hierarchical.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is evaluated. One change is that the public sector has become more subject to external evaluation. Another change is that the public sector has become more subject to internal evaluation. A third change is that the public sector has become more subject to self-evaluation.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is perceived. One change is that the public sector has become more respected. Another change is that the public sector has become more valued. A third change is that the public sector has become more appreciated.

The increase in the number of people employed in the public sector has also led to a number of changes in the way that the public sector is viewed. One change is that the public sector has become more visible. Another change is that the public sector has become more accessible. A third change is that the public sector has become more transparent.

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