

Private Company Services
High Net Worth

Wealth and Tax Matters

for individuals and private companies

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Includes an
index to all editions
of *Wealth and
Tax Matters*
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See "How to get *Wealth and Tax Matters*," on page 33.

Editorial

Welcome to another winter edition of *Wealth and Tax Matters*. The holiday season is often filled with travel and family gatherings, so we start this edition with articles that deal with planning with family members and family assets, as well as cross-border tax matters.

With the hope of dispelling some enduring myths, the first article (the second of two parts) deals with the most frequently misunderstood Canada-U.S. tax issues. The next two address family tax planning—purchasing a home for adult children and planning with credits when supporting elderly parents. The fourth article stresses the importance of proper tax planning with a TFSA to avoid unintended tax consequences on death.

The topics then shift from a personal perspective to more business-related issues. We revisit the familiar question of whether automobiles should be held personally or through a corporation, tax considerations in drafting shareholders' agreements and how to evaluate what your business is worth today. We also provide the final part of our series on long-term incentive plans for employees and how to provide a market for their shares.

This edition's last article discusses changes in the world of charities that could affect how future gifts are structured. At the end, we have added an index that covers this and all previous editions of *Wealth and Tax Matters*.

Thank you for reading our publication. We welcome your suggestions on how we can better bring you the information you need for handling your wealth and tax matters.



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Cross-border cocktail advice

The tax adviser's headache

(Part 2)



The change in seasons did not bring an end to the tax headaches of the tax adviser we told you about in the previous edition of *Wealth and Tax Matters* (Summer 2010 page 01). Here in Part 2 of this two-part article we deal with the remaining five of the ten most common misconceptions and questions that many Canadians have about U.S. estate and income tax planning issues.

6. I spent fewer than 183 days in the United States this year, so I don't have to worry about being a U.S. resident, right?

Well, it depends. You will be considered a U.S. resident for income tax purposes if you meet the "substantial presence" test for the calendar year, which occurs if you are physically present in that country for at least:

- 31 days in the current year; and
- 183 days during the 3-year period that includes the current year and the two years immediately before that, counting:
 - all days you were present in the current year;
 - 1/3 of the days you were present in the first year before the current year; and
 - 1/6 of the days you were present in the second year before the current year.

Therefore, even though you may be in the United States for fewer than 183 days in the current year, you may in fact be considered resident in the United States for income tax purposes.

However, you can avoid being classified as a U.S. resident by filing Form 8840 "Closer Connection Exception Statement For Aliens" with the IRS, which is available if you:

- are present in the United States fewer than 183 days during the current year;
- maintain a home in Canada;
- have a closer connection during the current year to Canada than to the United States; and
- have not taken affirmative steps to change your status to that of a lawful permanent resident of the United States.

Even if you have been present in the United States for more than 182 days during the current year, you could still avoid being classified as a U.S. resident under the Canada-U.S. Tax Treaty's tie-breaker rules. We recommend you contact your tax adviser if you are in this situation.

Another *Wealth and Tax Matters* article, “The Snowbirds Sing and the IRS Listens” (Autumn 2009, page 15) has more details.

7. If I give assets to my U.S. son during my lifetime or on death, will he be subject to U.S. inheritance tax?

Your son can receive gifts and inheritances without short-term U.S. tax consequences. In fact, he won't have to pay estate tax unless he still holds them (or substituted assets) on his death, because under U.S. law, estate tax is imposed on the value of the worldwide assets held on death, rather than when he receives a gift of property.

However, your son may have to file Form 3520 with the IRS to report gifts received from you, because you are not a U.S. person. This is merely a reporting form and creates no tax liability, but penalties for failing to file the form when required are severe.

You can protect assets from future U.S. estate tax on your son's death by leaving them to your son in a trust, either during your lifetime or on death. To ensure you are protecting your legacy from future U.S. estate tax, discuss the specifics of the trust with your tax adviser.

8. Is it true that I won't be subject to U.S. estate tax on death unless I own U.S. real estate?

Not necessarily!

Unfortunately, even though you are not a U.S. citizen or resident and you don't own U.S. real estate, you could still have to pay U.S. estate tax if you die owning “U.S. situs assets.” In addition to U.S. real estate, U.S. situs assets include such things as:

- shares in a U.S. corporation (including publicly traded securities)
- personal property located in the U.S., including art, automobiles, clothing, furniture, gold and jewellery;
- cash in a U.S. safety deposit box;

- deposits with U.S. brokerage firms;
- options for stock in U.S. corporations; and
- some life insurance policies.

And here's a surprise: the IRS will also look through an RRSP to the underlying assets to determine whether you own any U.S. securities in your RRSP. Please contact your adviser to determine whether specific investments are subject to U.S. estate tax, even if they are not listed above.

One good thing—U.S. estate tax will be payable only on your U.S. property and not on your worldwide assets.

9. Would I be crazy to listen to my neighbour, who says that because I'm a dual citizen living in Canada I have to file income tax returns only here?

Let's just say you would be ill-advised.

According to Uncle Sam, as a citizen of the United States you must file U.S. income tax returns regardless of where you live, and report your worldwide income. Fortunately, you can avoid double taxation by claiming foreign tax credit relief on your returns.

As part of your U.S. income tax filings you may also have to file other forms, depending on what gifts you may have received or made in the year or on account of your owning shares in certain corporations. For example, if you control a Canadian corporation or you have an interest in a Canadian company that holds significant passive investments, you may be required to file Form 5471 with the IRS. Penalties for failing to do so are severe, even if no tax may be due—\$10,000 for each missed year. Additional penalties may be assessed if the IRS notifies you that you must file this form.

But wait, there's more.

Each year, you are also required to disclose to the IRS information on your foreign financial accounts if their aggregate value exceeds \$10,000 and you have either a financial interest or signature authority over the account. Financial accounts include any bank accounts and any other investment savings, chequing and deposit accounts.

You must file the Foreign Bank and Financial Accounts (FBAR) forms by June 30 of each year. Failing to file or late filing can result in severe penalties, such as a \$10,000 penalty per account.

10. I've held a green card since 2003. Can I give it up without U.S. tax consequences?

Not so fast!

You are considered a “long-term” green card holder (i.e., you have held your green card in at least eight of the past 15 years). Because of this, if you give up your green card now, U.S. expatriation rules could apply. Unless you are exempt from these rules, giving up the card now could trigger an “exit tax.” For an explanation of the exemptions, see *Relinquishing U.S. Citizenship – Harder Than You Think* (Winter 2009, page 07).

If the U.S. exit tax applies, you are considered to have sold your worldwide assets at fair market value. If the capital gain arising on this deemed sale is greater than \$627,000 (adjusted annually for inflation), the net gain is included in your income in the year of expatriation and is subject to U.S. income tax. The IRS may allow you to defer paying the exit tax itself, but you must post adequate security and pay interest.

In addition, you might also have to pay income tax on the full value of certain assets, such as Canadian and foreign pension plans, RRSPs, IRAs and certain trust interests. The relevant rules dealing with these assets are complex and are not covered here.

As with all tax matters, the details are important. Please consult your adviser if you have specific questions.

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See “How to get *Wealth and Tax Matters*,” on page 33.

Happy Birthday! Here's your condo

Buying a home for your adult child



A significant proportion of parents with sufficient means buy condos or other homes for their adult children (those age 18 or older). This is not just our observation—an independent survey indicates that 10% of all Canadians who own or would consider owning a condo that is not their primary residence would make this type of gift.¹

Those entertaining this idea, perhaps as a safe way to build wealth for their children, should consider several tax, estate and family law matters. To help, this article reviews four ownership options, their tax implications and the income tax planning related to the principal residence exemption.

The options all assume that you are in the highest income tax bracket, with a 46%² marginal tax rate, and that the condo you wish to purchase for your adult child costs \$250,000. Of course, before selecting an option, all family law implications should be confirmed by legal counsel in the child's province of residency.

Option 1 – Purchase condo for \$250,000 in your name

Property or real estate could be something you are looking at as a long-term investment. Why not consider letting your children live in the condo in the interim? Any gain on the eventual disposition of the condo will be exempt from income tax if you can claim the property as your principal residence.

The problem is that each family unit (which encompasses you, your spouse or common-law partner and any unmarried children under age 18) is entitled to designate just one property as its principal residence for each year. Therefore, if you and your spouse own more than one property, such as your home and a condo for your child, the principal residence exemption will not be available on the sale of the condo if your home is designated as your principal residence.

Assuming the home is designated as the principal residence for all the years that you have owned the condo, and that the value of the condo has appreciated from \$250,000 to \$450,000 by the time it is sold (or is deemed to be sold upon your death), the capital gains tax that would arise on the disposition of the condo will be \$46,000 (i.e., $1/2 \times \$200,000 \times 46\%$), because only half of the capital gain is taxed.

If you purchase the condo for your child and hold the property in your name, upon your passing, the condo will be included as one of the assets

¹ TD Canada Trust survey, May 2010. www.cnw.ca/en/releases/archive/May2010/05/c8758.html.

² Top 2010 marginal rates in Canada vary from 39% in Alberta to 50% in Nova Scotia.

For some provinces and territories, different rates may apply to smaller estates (less than \$50,000).

	Fee schedule (estates over \$50,000)	Example fees		
		\$500,000 value	\$2,000,000 value	\$5,000,000 value
Alberta	\$200 to \$400	\$400		
British Columbia	\$358 + 1.4% of portion > \$50,000	\$6,658	\$27,658	\$69,658
Manitoba	\$70 + 0.7% of portion > \$10,000	\$3,500	\$14,000	\$35,000
New Brunswick	0.5% of estate	\$2,500	\$10,000	\$25,000
Newfoundland and Labrador	\$90 + 0.5% of portion > \$1,000	\$2,585	\$10,085	\$25,085
Northwest Territories	\$200 to \$400	\$400		
Nova Scotia	\$902 + 1.523% of portion > \$100,000	\$6,994	\$29,839	\$75,529
Nunavut	\$200 to \$400	\$400		
Ontario	\$250 + 1.5% of portion > \$50,000	\$7,000	\$29,500	\$74,500
Prince Edward Island	\$400 + 0.4% of portion > \$100,000	\$2,000	\$8,000	\$20,000
Quebec	Nominal fee			
Saskatchewan	0.7% of estate	\$3,500	\$14,000	\$35,000
Yukon	\$140	\$140		

Although Quebec does not levy probate fees, wills (other than notarial wills) must be authenticated by the Superior Court of Quebec. A nominal fee applies.

subject to probate fees. When a will is subject to probate, with limited exceptions, probate fees are paid on the gross value of the assets passing through the will, as shown in the table.

The highest rates are Nova Scotia's 1.523% and Ontario's 1.5%.³ As outlined on page 01 of the winter 2009 edition of *Wealth and Tax Matters*,⁴ planning can sometimes reduce probate fees.

If your child is married or may marry in the future, this option could provide the best protection for you and your child should the child divorce. Matrimonial property regimes differ from province to province. In Ontario, the property accumulated by spouses during marriage is generally "equalized" upon the breakdown of the marriage under the *Family Law Act*. With limited exceptions, an "equalization payment" is the payment one spouse makes to another to ensure that each spouse leaves the marriage with an equal share of any growth in the net worth of both parties during the marriage.

The matrimonial home is treated differently from the rest of the spouses' property. It will be included in calculating the equalization payment even if it was acquired by way of gift or inheritance and even if it was owned pre-marriage by one of the spouses and continues to be owned by that spouse at separation. In option 1, the condo would be in your name, so normally the value of the condo would not be subject to equalization upon your child's marital breakdown.

Option 2 – Gift cash of \$250,000 to child who purchases the condo

Giving cash to your child has no tax implications. However, if you have more than one child and you give cash to just one, you may want to think about equalizing their inheritances by leaving your other children with portions of other assets or life insurance proceeds.

Having a child hold the condo in his or her own name has significant tax

advantages. The most obvious is that your child potentially can be exempt from tax on the gain when the condo is sold, by using his or her own principal residence exemption. This could save the family \$46,000 of taxes on the \$200,000 appreciation of the condo discussed in option 1. In addition, because you do not own the condo, you will not pay probate fees on its value upon your death.

This option likely will not protect the condo from equalization should your child divorce. Your child's spouse might end up receiving half the value of the condo in the event of a marital breakdown—probably not the result you intended.

Option 3 – Lend funds of \$250,000 by way of a mortgage to child who purchases the home

Giving your child a mortgage for the full value of the property may be preferable to providing an outright gift or staying

³ Depending on the value of the estate, a jurisdiction with a higher percentage rate may produce a lower probate fee than one with a lower percentage rate, because of the fixed dollar portion of the calculation.

⁴ Trust basics part 4: Estate planning with alter ego and joint spousal trusts.

on the title of the property. A mortgage may assist with family equality issues. The mortgage to your child should be interest-free, because interest income would be taxable in your hands and the child would not be able to deduct any interest for tax purposes.

As with option 2, when the condo is sold, your child can use his or her principal residence exemption to avoid paying tax on the realized gain. Without planning, you likely will be subject to probate fees on the amount of the mortgage if it is still outstanding when you die. Because the child owns the condo subject to a mortgage, we understand that this plan could provide better protection to you and your child under family law legislation should the child divorce while owning the condo.

Option 4 – Gift funds of \$250,000 to a trust that purchases the home

The final option discussed here is to give cash to a discretionary family trust, which would acquire the condo for your child. If no suitable trust already exists, you would first settle a trust with a non-income producing asset, such as a gold coin.

Family trusts are popular vehicles for sharing wealth with family members

because they offer the trustees the flexibility to accommodate the changing and competing needs of the beneficiaries. (See, for example, page 07 of the autumn 2009 edition of *Wealth and Tax Matters*.⁵ The separation of legal and beneficial ownership of properties held in the trust allows the parents (as trustees) to retain legal control over the properties set aside for the benefit of their children (as beneficiaries).

You could be one of three trustees. Decisions are made by majority vote. The discretionary beneficiaries of the trust could include your spouse, your children and your grandchildren. You should not be a beneficiary, because that would trigger the attribution rule in subsection 75(2) of the *Income Tax Act* (see “Trust basics part 3” in the autumn 2008 *Wealth and Tax Matters*).

If the trust is set up properly and your child lives in the condo the trust should be able to claim the principal residence exemption, which would reduce or eliminate any gain that the trust would otherwise have on the disposition of the condo. For this to work, your child, his or her spouse or common-law partner and any unmarried children under age 18 must have not designated another property as a principal residence for the same years that the trust owned the condo.

Although this option is more complex, it is more flexible, because the beneficiary who will ultimately receive the condo or the proceeds of its sale can be determined by the trustees in the future. This option also minimizes probate fees, because the cash you give to the trust will not be included in the value of your estate that is subject to probate fees.

Conclusion

The ownership structure for purchasing a condo or other home for your adult child that is best for your family will depend on your family’s situation and your own personal objectives. While options 2, 3 and 4 should minimize the future tax that is payable on the capital gain realized on the disposition of the condo, all implications of each option should be considered to ensure your objectives will be met.

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⁵ Family trusts – A way to finance a child’s education and reduce your family’s overall tax bill.

Elderly parents

Tax credits and planning



This article reviews some income tax credits and planning considerations that the many children who support elderly parents should be aware of. Nearly one in five Canadians aged 45 years or older provided some form of unpaid care or support to a senior with long-term health concerns, according to a 2008 Statistics Canada Report.¹ In the years ahead, an increasing proportion will find themselves caring or providing for elderly parents in some fashion.

Non-Refundable Income Tax Credits and Personal Amounts (PAs)

Non-refundable income tax credits reduce the annual income tax liability of an individual. In some instances, a dependent individual who has insufficient income to fully use his or her credits may transfer unused credits to family member(s) who support them.

For 2010, federal non-refundable credits are 15% of the applicable personal amounts (PAs) and medical expense amounts. PAs are indexed annually. The provinces and territories offer similar non-refundable credits, but for simplicity only the federal non-refundable credits are discussed here.

Infirm Dependants

A supporting child may be eligible to claim an amount for an elderly parent who:

- was dependent on the child for support; and
- had an impairment of physical or mental functions.

In 2010, the maximum PA for an infirm dependant is \$4,223, but this is reduced by the parent's net income for the year in excess of \$5,992. If more than one child provides support, the claim may be split among the supporting children, not necessarily equally. For the child or children to claim the Infirm Dependant PA, the parent need not live with the child or children.

¹ See "Eldercare: What we know today," in *Canadian Social Trends*, no. 86 (11-008-XWE, free). Authors Kelly Cranswick and Donna Dosman released October 21, 2008 (<http://www.statcan.gc.ca/pub/11-008-x/2008002/article/10689-eng.pdf>)

Caregivers

A child may claim the caregiver PA if:

- the child did not claim the infirm dependant PA; and
- the parent:
 - lived with him or her at any point during the year;
 - had an impairment of physical or mental function; and
 - had a net income at or below \$18,645.

In 2010, the maximum caregiver PA is \$4,223 and will be reduced by the parent's net income for the year in excess of \$14,422.

Because the infirm dependant PA and the caregiver PA cannot both be claimed, the choice matters. If the parent lived with the child, the caregiver PA will produce a result that is the same or better than the infirm dependant PA. If the parent lived with more than one child during the year, in separate households, the caregiver PA may be apportioned between the children in any reasonable way. If the children cannot agree, the Canada Revenue Agency will apportion the amount as it sees fit.

Disabilities

To be eligible for the disability PA, the individual must have a severe or prolonged impairment that markedly restricts the ability to perform the functions of daily living. In 2010 the federal disability PA is \$7,239.

In the first year of claim, the individual must have a Form T2201 completed by his or her medical practitioner, certifying the impairment. The form must be submitted to the Canada Revenue Agency.

A child may be able to claim all or a part of a dependent parent's disability PA if the parent lived with him or her at any point during the year and the child provided at least some of the necessities of life (food, shelter and clothing). To transfer the disability PA, the parent must not have fully used the disability PA. To claim the transferred disability PA, the child must have claimed or have been eligible to claim either the infirm dependant PA or caregiver PA for that parent.

Medical Expenses

A child who paid eligible medical expenses for a dependant parent can claim medical expenses for that parent. The claim on the child's personal tax return would be the lesser of:

- the actual expenses, less 3% of the parent's net income for the year; and
- \$10,000.

If more than one child supports the parent, each supporting child can claim up to \$10,000 (subject to the net income restriction) as long as the amount claimed does not exceed the medical expenses paid by the particular child on behalf of the parent.

There are many eligible medical expenses outside of prescription drugs

and fees for medical services, such as bathroom aids, power-operated guided chairs for use on a stairway, and scooters used in place of a wheelchair (but prescriptions may be required for all of these). Also, some costs of renovating a home to help a person with a mobility impairment function better can qualify as eligible medical expenses. No prescription is required.

If medical treatment is not available within 40 kilometres of home, the cost of transportation to seek treatment may be claimed. If the patient must travel more than 80 kilometres from home for treatment, the cost of meals and accommodation may be claimed as well. Travel expenses can also be claimed for a caregiver, if a doctor certifies that the patient would be unable to travel without assistance.

Another component of a medical expense claim is attendant care. Fees paid to an unrelated person qualify if for:

- food preparation (excluding the cost of food);
- housekeeping, laundry;
- health care, social activities;
- transportation; or
- certain salon services.

To include attendant care as eligible medical expenses, the parent must have filed a disability certificate (Form T2201) with the CRA.

Eligible attendant care expenses can be provided to the parent in the child's home, a retirement home, or a long-term care facility. As with other medical expenses, if the parent is dependent on the child and the child paid for the parent's medical expense, the child may claim the attendant medical expenses (subject to the ordinary medical expense restrictions discussed above).

If the parent's attendant is an employee of the child, the child may have certain payroll responsibilities, such as tax withholdings and T4 reporting.

Fees paid for full-time care in a nursing home, including fees for food, accommodation, nursing care, administration, maintenance and social programming generally can be claimed in their entirety as medical expenses. The parent must have filed a disability certificate (Form T2201) with the CRA to include nursing home fees as eligible medical expenses. However, making this claim prevents a claim for attendant care expenses or for the disability amount transferred from the parent. The claim will also be restricted by the medical expense limits, discussed above.

The child cannot claim the disability amount transferred from the parent if the claim for attendant care is more than \$10,000 or a claim for nursing home fees is made. To optimize the overall result for parent and supporting child, eligibility for all claims should be reviewed before making a claim for attendant care or nursing home expenses.

Planning considerations

With the rising costs of health care, children may be concerned about funding the medical expenses of one or both parents. If a family-owned business has had the benefit of previous tax planning, a discretionary family trust could exist, and a parent could be both a capital and income beneficiary. Income or capital of the trust could be allocated to the parent to cover care expenses. Income that has already been taxed within the trust will neither create a tax liability when received by the capital beneficiary of the trust nor reduce the PAs available for transfer by the parent.

Caring for ailing parents may require children to take time away from their jobs. In certain situations, applications can be made to the Canadian Employment Insurance system for compassionate care program benefits. The Compassionate Care Benefits program provides up to 26 weeks of employment insurance benefits to individuals who have had at least a 40% decrease in their weekly earnings because they are caring for or supporting a gravely ill family member. To qualify, a minimum number of insurable hours must be worked.

Should the parent require longer-term care and support, children may find that their earnings have decreased, and may have to reconsider their own retirement savings strategies.

For example, the tax benefits of contributing to a registered retirement savings plan (RRSP) may be eroded for a child now in a lower tax bracket. In addition, the child might have to tap into RRSPs for funds. However, withdrawals from RRSPs are subject to income tax withholding. In contrast, Tax-free Savings Accounts (TFSA) allow the contributor to accumulate earnings tax free and the withdrawals are not taxable.

Caring for an elderly parent can be challenging, both financially and emotionally. The Canadian government (as well as the provinces and territories) has provided income tax credits and programs that help. Speaking with your professional adviser about your unique situation will help you ensure that you are making the most of the available credits and programs.

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See "How to get *Wealth and Tax Matters*," on page 33.

Is a Tax-Free Savings Account (TFSA) always tax free?



Tax-Free Savings Accounts (TFSAs) quickly became a popular form of investing and saving after they were introduced in 2009, mainly because—as their name suggests—income earned inside the TFSA and any capital appreciation of assets inside the TFSA are both free of income tax.

But are TFSAs always “tax free”?

Perhaps surprisingly, the answer to this question is “no,” because TFSAs generally lose their tax-exempt status after the death of the TFSA holder, although the rules are more complicated than that.

Consider Steve, who is the holder of a TFSA currently worth \$20,000. Steve is a resident of Ontario, and has a spouse, Stephanie, and one adult child, Adam. What are the income tax implications if Steve dies?

Beneficiary designations

First, we will discuss the general rules with respect to beneficiary designations.

All provinces and territories let individuals designate a successor holder (i.e., a beneficiary) to their TFSAs in the event of death, by means of a separate designation outside

of their will. This generally involves filing the appropriate forms with the financial institution where the TFSA is opened. The beneficiary designation can be changed by the holder of the TFSA over his lifetime, at his or her discretion.

Scenario 1 – Surviving spouse is designated as successor holder

Let’s assume that Steve designates his spouse, Stephanie, to be the successor holder of his TFSA on his death by giving her:

- all of the rights as the holder of the arrangement; and
- the unconditional right to revoke any beneficiary designation made by the individual under the arrangement.

If she survives him, Steve’s death will have no income tax consequences in respect of the TFSA; Stephanie will continue as its holder. Any income earned, or capital appreciation, inside Steve’s former TFSA would continue to be tax free.

Alternatively, the assets of Steve's TFSA could be transferred to Stephanie's own TFSA, regardless of whether Stephanie has available contribution room, as long as Stephanie makes this contribution before the end of the first calendar year after the year in which Steve dies.

The key step is that Stephanie must be designated as the only successor holder of his TFSA. If Steve had made partial designations in favour of Stephanie and Adam, the income tax consequences would be different, as noted below.

Scenario 2 – Surviving spouse but no beneficiary designation

The TFSA could exist without a beneficiary having been designated if the appropriate forms are not filed with the financial institution and the entire TFSA is left to a beneficiary under Steve's will. The *Income Tax Act* allows for "exempt contributions" to be made to a spouse's TFSA with no effect on the surviving spouse's

TFSA contribution room. However, the following conditions must be met after the death of the TFSA holder:

- the contribution must be made to the surviving spouse's TFSA by the end of the first calendar year after the year of the individual's death (referred to as the "rollover period");
- a payment (referred to as a "survivor payment") must have been made to the survivor during the rollover period as a consequence of the individual's death, directly or indirectly out of his former TFSA;
- within 30 days of making the contribution, the survivor must designate the contribution in prescribed form filed with the CRA in prescribed manner; and
- the contribution must be the least of:
 - the total survivor payment,
 - the fair market value of the assets in the deceased's TFSA immediately before death, and
 - nil, if the deceased had an excess TFSA amount immediately before his death or if the survivor payment is made to more than one survivor.

Overall, if these conditions are satisfied, then (much like in Scenario 1) a contribution to a TFSA that is an

"exempt contribution" would not result in any tax liability. However, a key difference here is that all earnings and appreciation of the TFSA arising after Steve's death would be taxable in Stephanie's hands, as the surviving spouse. Consequently, making a beneficiary designation, in prescribed form and manner, is the more tax-efficient solution. However, once again, the entire TFSA balance must be transferred to Stephanie for it to be considered an exempt contribution.

Scenario 3 – No surviving spouse but no beneficiary designation

If no beneficiary designation is made and there is no surviving spouse, in general, the TFSA, which is a trust, retains its tax-exempt status until the earlier of the cessation of the trust and the end of the calendar year following the year in which the holder dies (referred to as the "exemption-end time").

Assume that Steve dies on April 15, 2011, with no surviving spouse. His TFSA account balance is \$20,000. The TFSA increases in value to \$22,000 by December 31, 2012, the date the TFSA trust distributes all of its assets to Adam. In this case, if the trust makes the appropriate designation, Adam would receive \$20,000 tax-free, and would be required to include only \$2,000 of the \$22,000 received in income. However, none of the \$22,000 can be added to Adam's TFSA as an

exempt contribution, because he is not a surviving spouse of the deceased.

In summary, any value in the TFSA accrued before the date of death of the holder may be distributed tax free to a designated beneficiary of the TFSA or to an individual designated under a will, whether or not that individual is the TFSA holder's spouse. The only portion of the TFSA assets that may have to be included in the income of the recipient is income earned or appreciation that arises after the death of a TFSA holder.

Scenario 4 – No surviving spouse and TFSA continues to exist after exemption period

As described above, the exemption-end time is the end of the calendar year after the taxation year in which the holder of the TFSA dies. If the TFSA trust continues to exist, it becomes a taxable trust. In Steve's case, if the assets are not distributed to the beneficiaries before December 31, 2012, Steve's TFSA will continue as a taxable Canadian trust. As discussed in scenario 3, any increase in value of the trust from the date of death to December 31, 2012 (the "exemption-end time") and any income earned during this period will be taxable in the trust's first taxation year that begins after the exemption-end time.

This taxable income may either be taxed inside the trust, or the trustees may allocate or distribute this income to the beneficiaries of the former TFSA trust under regular trust rules.

Beneficiary elections in Ontario

Ontario was slow to introduce measures to permit direct beneficiary designations to be made for non-insurance TFSAs. The provisions were put in place on May 28, 2009, although Ontario-resident individuals could create TFSAs beginning January 1, 2009. Individuals who opened TFSAs before May 28, 2009, should contact their plan administrators to update their beneficiary designations to ensure that any beneficiary designations bear a date after May 28, 2009. Otherwise, they may be faced with some of the inadvertent tax consequences summarized above.

In summary

During the TFSA holder's lifetime, income inside the TFSA and any appreciation of assets generally is tax free—but not necessarily afterward. Significant income tax consequences could arise upon the death of the TFSA holder because, despite its name, the TFSA may not always be tax free.

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Dude where's your car?

Where and how to hold your vehicle



Those who use a vehicle for business purposes often are faced with an apparently simple question. How should I hold my vehicle? Tax rules can make simple answers elusive.

Essentially, two ownership alternatives are available: personal or corporate. In either case, when a vehicle is made available to you the tax consequences can depend on:

- the personal use of the automobile;
- the original cost of the automobile;
- the length of time the vehicle will be held; and
- whether the vehicle is imported or domestic, and the possible effect on resale value.

Corporate Ownership

A vehicle that is held in the corporation but made available for the benefit of the employee certainly will have some personal use components, even if only driven between home and the workplace.

The corporation can deduct reasonable operating expenses and capital costs for a vehicle supplied to the

employee. Examples are gas, repairs and maintenance, licence fees and insurance costs. On the other hand, capital costs comprise either the purchase price of the vehicle (including interest) or leasing costs.

Each “passenger vehicle” that costs more than a prescribed amount must be included in its own capital cost allowance (CCA) class 10.1. Vehicles not included in class 10.1 are included in class 10. Cars in either class are depreciable for tax purposes at the CCA rate of 30%, on a declining balance basis. For Class 10.1 passenger vehicles, the company can claim CCA on only \$30,000 plus sales taxes. The company receives no tax relief for any excess of the actual purchase price over the \$30,000 limit.

The deduction for interest on money borrowed to purchase a passenger vehicle is limited. For vehicles purchased in 2010, the maximum deduction is \$300 per 30-day period during which the interest was paid or payable.

Table 1: The standby charge calculation

Company-owned automobile		Company-leased automobile
2%		2/3
x		x
Original cost		Monthly lease cost
x		x
Number of months or part months in the year the car was available		
	x	
Reduction for low personal use ¹		
	=	
Standby charge before reimbursements		
	-	
Reimbursements by employee to employer ²		
	=	
Standby charge		

¹ The standby charge can be reduced if the car is primarily (generally more than 50%) used for business purposes and the personal-use kilometres averages less than 1,667 per month.

² The payment must be made by December 31.

When the vehicle is provided to an employee or a person related to the employee, the employee usually will be considered to have received two benefits:

- a standby charge benefit; and
- an operating cost benefit.

The employer is required to compute both, and to report the aggregate to the employee and to the income tax

authorities. The corporation must also calculate the implicit sales tax benefit to the employee and remit sales taxes in respect of these benefits.

Standby charge benefit

The standby charge must be computed whenever a corporately owned or leased vehicle is made available for an employee's personal use (or a person related to the employee) by virtue of his or her employment. The standby charge is always calculated on the full original purchase price, so the inevitable decline in value of the vehicle over time is not recognized in this calculation.

Operating cost benefit

An operating cost benefit should also be included in the employee's income when the corporation pays for the operating costs. The typical calculation for the benefit is:

$$\begin{aligned} & \text{Personal kilometres driven} \\ & \text{in the year} \\ & \times \text{ Prescribed amount } (\$0.24 \text{ for } 2010) \\ & - \text{ Any reimbursement made by the} \\ & \text{employee before February 15 of the} \\ & \text{following year.} \end{aligned}$$

The operating cost benefit can be avoided if the employee reimburses the corporation for 100% of the personal use portion of the operating cost before February 15, of the following year.

Employees who use the vehicle more than 50% of its use for business can elect to calculate the operating benefit using the standby charge. The calculation would be half of the standby charge before reimbursements, less any reimbursements made by the employee before February 15 of the following year.

Taxable benefits to the employee can be minimized by:

- reducing personal kilometres;
- buying or leasing less expensive vehicles; or
- paying a higher salary and having the employee purchase or lease the vehicle personally.

Generally, it is best to put a vehicle in the corporation if you will hold it for a short period and it is a domestic (because its value may well decline faster than that of an import). However, a company-owned vehicle is often a point of friction with the Canada Revenue Agency. The CRA will certainly request proper documentation to validate the deductions and calculations of taxable benefits.

Table 2: Business Vehicle Expense Summary

			2010 Prescribed limits	
Deduction limits	Owned vehicles	Maximum monthly interest deduction	\$300	
		Maximum capital cost on which CCA may be claimed	\$30,000 + sales tax	
	Leased vehicles	Thresholds used to determine the maximum deduction for lease payments		Lease cost limit
				Monthly lease limit
Manufacturer's list price limit			\$35,294 + sales tax	
Automobile allowances	Per-kilometre allowance	Same limits as tax-exempt allowances, below		
Taxable benefits	Tax-exempt allowances	Kilometres driven in the Yukon, NWT or Nunavut	First 5,000	\$0.56
			Each additional	\$0.50
		Kilometres driven in all other locations	First 5,000	\$0.52
			Each additional	\$0.46
Operating cost benefit	Persons employed principally in selling or leasing automobiles		\$0.21	
	All other employees		\$0.24	

Personal ownership

If the vehicle is held personally, whether purchased or leased, and was driven for business purposes, a pro-rated portion of operating costs and capital costs can be deducted when computing an individual's personal income for the year.

Operating costs can be deducted for the percentage of business-use kilometres to total kilometres driven during the year. Special rules that apply to salespersons and contractors limit

the deductions allowed, but are not covered here. Parking costs are not pro-rated because generally they are incurred for the purposes of earning or producing income. The CCA will be pro-rated for the percentage of business use for an employee who is entitled to claim CCA.

An approach that is sometimes simpler than having the employee claim vehicle expenses on his or her personal tax return is for the employer to pay an allowance to cover personal costs of operating the vehicle. This can be done in two ways:

- If the allowance is based on kilometres travelled for business purposes, the allowance will be tax free to the employee, as long as it is reasonable. The CRA has defined "reasonable" in terms of per-kilometre limitations on the amount that an employee can receive as an allowance. (See Table 2.) The employee is not required to report the reimbursement in his or her personal income tax return for the year, yet the company gets a full deduction for the payment. If one of the objectives is to minimize interaction with the tax authority both personally and corporately, this is clearly the way to go.

- If the allowance is constant and not based on actual expenses incurred by the employee, it will be a taxable benefit to the employee. However, paying a non-accountable allowance generally forces the employee to track and document personal vehicle expenditures and claim the relevant business portion on his or her annual tax return, to mitigate the tax. Complexity and potential with the CRA are not avoided, but might even be increased, because both corporate and personal tax deductions are being claimed for vehicle expenses.

Corporations will be able to deduct allowances only up to the prescribed rates in Table 2, unless the employee is required to include the entire allowance in his or her income. In that case the corporation will be able to deduct the entire allowance, regardless of the amount.

Corporations that pay for a portion or all of the employees' expenses should consider kilometre-basis reimbursements, being careful to ensure that they do not exceed the prescribed kilometre rate.

Some rules of thumb—hardly intuitive—help in generalizing from this rather complicated set of rules:

Generally the more the business use, the better it is to own the vehicle personally, in order to exploit the ability to receive significant tax-free per-kilometre reimbursements and to minimize friction from the CRA.

On the other hand, if there is little business use then it may be better to consider corporate ownership to exploit the full tax deductibility of the ownership and operating costs to the company, even though considerable personal taxable benefits might have to be reported. However, if the vehicle is expensive, and likely to be held for a long period, the taxable benefit considerations will often dictate that the vehicle be owned personally, because the decline in value of the vehicle will never be recognized in the taxable benefit calculation. Corporate ownership therefore tends to work better with “fleet

cars,” for which the original purchase price is less, and replacement after one to three years is common.

Conclusion

That seemingly simple question—where and how should I hold my vehicle?—is more involved than what you would expect. To see what makes the most sense requires a calculation of the varying scenarios to ensure you have made the appropriate decision on where and how to hold your vehicle.

For even more information on this topic, see *Car Expenses and Benefits – A Tax Guide* at www.pwc.com/ca/carexpenses

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See “How to get *Wealth and Tax Matters*,” on page 33.

Taxed by association

Shareholders' agreements (Part 1)



Think you only need to speak with your lawyer when developing the terms of your shareholders' agreement? Think again!

A number of important tax implications must be considered. Without proper planning, unintended—and unpleasant—tax results can arise. Whether you are currently contemplating a shareholders' agreement, are developing one, or already have one in place, this is a topic that has to be taken seriously.

In this first of a series of articles addressing tax considerations essential to shareholders' agreements, we discuss how buy-out rights can result in the application of the associated-company rules.

Why is “association” important?

Several implications arise when companies are considered to be associated for tax purposes, including:

- sharing of the \$500,000 business limit for the small business deduction;
- determining the balance due date for tax instalments; and
- limiting the amount of investment tax credits for scientific research and experimental development (SR&ED).

How are companies associated?

Generally, companies are considered associated when they have common control (for example, parent and subsidiary companies or a common

majority shareholder of two companies). Associations can also occur when two companies are controlled by related persons, or related groups, but only if there is cross-ownership of shares (i.e., the person or related group that controls one company must own at least 25% of the shares of the other company).

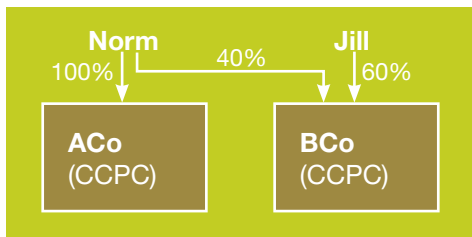
In assessing control and share ownership, if rights have been granted to a person or other entity (whether the right is immediately exercisable or contingent on an event), that person or entity will be deemed to have exercised those rights. For example, if a person is granted a right to acquire shares, he or she will be deemed to own those shares in determining whether companies are associated. The only exception is when the rights are contingent on the death, bankruptcy or permanent disability of an individual.

Why are the terms of a shareholders' agreement important?

The terms of a shareholders' agreement can include provisions that grant rights to acquire shares in various circumstances. These terms must be considered carefully to ensure they do not cause the company to be associated with another company. In particular, rights that could permit

a person or entity to buy out another shareholder on certain triggering events must be reviewed.

Take for example the following scenario: Norm and Jill are both Canadian residents but are not related. Norm and Jill own 40% and 60% of the common shares of BCo, respectively. Norm also owns 100% of the common shares of ACo.



While Norm owns 40% of the shares of BCo, ACo and BCo should not be associated companies because he does not control BCo and is not related to the person that does control BCo. As a result, each has the benefit of the full \$500,000 business limit for the small business deduction (among other benefits).

But what if Norm and Jill entered into a shareholders' agreement with a term that, upon the death, incapacity or insolvency of one shareholder (the "triggering shareholder"), the other has the right to purchase his or her shares? In this circumstance, Norm will be considered to have a right to acquire Jill's shares (and vice versa).

Will Norm therefore be deemed to own 100% of BCo for the purposes of the associated-company rules?

As stated above, Norm will be deemed to own the shares to which he has rights unless those rights are contingent on death, bankruptcy or permanent disability. Unfortunately for Norm and Jill, their shareholders' agreement is unlikely to define incapacity and insolvency in a way that would qualify as permanent disability or bankruptcy for the purposes of the associated-company rules. For instance, the Canada Revenue Agency (CRA) considers disability to be permanent only if there is no reason to believe the disability will not continue throughout the lifetime of the individual. As a result, Norm likely will be deemed to own 100% of the shares of BCo, making ACo and BCo associated companies.

The same consequence would arise for buy-out rights that are contingent on the retirement of a shareholder from the business or on a breach of the shareholders' agreement.

Can association be avoided?

Properly crafted, a shareholders' agreement can provide for buy-outs without the application of the associated-company rules. For example, suppose Norm and Jill's shareholders' agreement provided that, in the event of insolvency or incapacity, BCo is required to purchase for cancellation the shares held by the triggering shareholder. In this scenario, Norm should not be considered to have a right in respect of any shares (unless he has control over the triggering event). As a result, ACo and BCo would remain unassociated.

Norm and Jill will have to consider, however, whether BCo would be able to fund the purchase of shares itself and, if not, how funding could be obtained. As well, such a term could have other tax implications to be thought through, such as the potential application of Part VI.1 tax.

In addition, the CRA has confirmed that certain common terms will not result in rights that trigger a deemed ownership for the associated-company rules.

Among these are:

- a right of first refusal;
- a shotgun clause;
- a drag-along right; and
- a piggyback clause.

Next steps?

If you have a shareholders' agreement in place, you should review its terms with your tax adviser to ensure there are no unintended tax results. If you are contemplating or developing a shareholders' agreement, you should consult with your tax adviser to ensure all tax matters have been considered.

In the next edition of *Wealth and Tax Matters*, Part 2 of this shareholders' agreement series will begin to examine planning for the death of a shareholder and the terms to be included in a shareholders' agreement.

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Developing an incentive compensation program (Part 3)

Liquidity events and recent changes to equity compensation



The two previous parts of this article discussed a step-by-step approach to designing a long-term compensation plan, and the key considerations for stakeholders: shareholders, employees and the employer (company).¹

After the company has implemented an incentive compensation program and involved the employees in the program, it's time to think of ways the individuals can capitalize on the expected growth.

This third and final part of the article discusses the considerations for providing a market for the shares (i.e., liquidity) and recent budget proposals—specifically how these proposals might change a company's method of providing a long-term incentive plan to employees.

Overview

An employee who becomes a shareholder on the exercise of a stock option gets certain rights. A clearly worded shareholders' agreement should be in place to help define these rights, and to assist in resolving any disputes that may result. In particular, new shareholders will want to know how they can capitalize on their investment, and how they can exit the investment if necessary.

An individual may be considered for tax purposes to have disposed of shares upon:

- ceasing to be a resident of Canada; or
- death.

Circumstances that might prompt an actual disposition include:

- retirement from the company;
- moving to other employment outside his or her corporate group;
- needing substantial funds as a result of his or her disability, or that of a family member;
- other financial needs; or
- receiving requests from individuals who want to acquire more shares.

Providing a market for the shareholders

A market can be created for the shares in a number of ways. This can lead to a more effective compensation program because when employees are also shareholders, they know that their

¹ *Wealth and Tax Matters* Winter 2010, p. 18 and Summer 2010 p. 18.

ultimate reward for holding the shares is not limited to special situations when the company undergoes a “liquidity event” — such as an initial public offering (IPO) or a sale to a third party.

Provisions can be inserted in the shareholders’ agreement to allow sales between shareholders (a willing buyer or seller), although guidelines should limit the percentage of ownership changes that could be permitted without board or shareholder approval.

If it is not possible to structure a private sale, an operating company (OPCO), or someone related to OPCO, might consider redeeming or acquiring the shares for cancellation. Unfortunately, this often produces adverse tax results, because a deemed dividend² may arise, as well as a capital loss. While an employee might expect a capital gain, or even minimal tax consequences, a large deemed dividend and a capital loss (without capital gains to offset the loss) is a harsh result.

One way to overcome this problem is to set up a separate company (let’s call it Newco) to repurchase the shares. It is critical to ensure that this company is at arms’ length to the main operating company (OPCO), through the ownership of voting shares by third parties. The OPCO will fund the repurchase by subscribing for non-voting preference shares of Newco,

and through a series of transactions the shares held by the departing shareholder will be retired.

These methods of providing liquidity help to promote ownership, and encourage employees to be part of the continuing success of the company.

Recent changes

The March 2010 federal budget proposed changes that will alter the relative benefits of different methods of delivering compensation to employees.

Employees are allowed a deduction in computing income at 50% of the stock option benefit if:

- the employee is arm’s length to the company;
- shares are “plain-vanilla” common shares; and
- the exercise price is at least equal to the fair market value of the underlying shares at the date of grant.

Companies had been able to buy back the option for cash and obtain a deduction in computing income, while the employee retained the 50% deduction. The budget proposes instead that the 50% deduction be available to employees only if the employee acquires the stock or the employer agrees to not take a deduction if cash is paid.

Companies can issue stock (referred to as restricted stock) that includes restrictions on the shareholder’s right to dispose of the share, while preserving the right to vote the shares and to receive dividends. In the past, stock options were a more efficient way of providing compensation than restricted stock, while giving the employee the same after-tax compensation. That changed with the effective elimination of the corporate deduction for cash-settled stock benefits.

Suppose the company wants to provide an employee with after-tax compensation of \$100,000. The chart shows that this would cost the company \$186,602 of cash salary and compares the cost of three other options. The following chart shows the relative employer costs for the four situations (with the corporate tax rate assumed to be 16.5%).

In the past, using the stock option plan was marginally preferable, largely because the company received a deduction and the employee was eligible for the 50% stock option deduction. Now that the tax advantage has swung towards the Restricted Stock in Trust plan, it may be worth considering despite the additional complexity.

² The deemed dividend is the difference between the redemption amount and the paid-up capital of the underlying shares.

Comparative Cash Costs for Employer – \$100,000 of Net Compensation to Employee

	Cash	Stock Options	Restricted Stock	
	<ul style="list-style-type: none"> Cash compensation is paid to the shareholder 	<ul style="list-style-type: none"> Stock option is purchased back by the company for cash Company claims the deduction Employee is not eligible for the 50% stock option deduction 	<ul style="list-style-type: none"> Company does not take the deduction Employee claims the 50% stock option deduction 	<ul style="list-style-type: none"> Company funds a Restricted Stock in Trust program Employee acquires the share when the value was \$10 per share Employee holds shares for at least two years after exercise (to take advantage of the CCPC stock deduction) Employee sells for \$20 per share
Employer cash cost	\$186,602	\$130,217	\$113,125	
Employer tax benefit	\$30,789	\$0	\$0	
Net employer cash outflow	\$155,813	\$130,217	\$113,125	

Comparison of Restricted Stock in Trust with Stock Option

	Restricted Stock in Trust	Stock Options
Shares	Treasury shares used	
When taxed	When shares are disposed of, because the shares will be CCPC shares.	When shares are disposed of, for CCPC shares (when option is exercised, for non-CCPC shares).
CCPC 2-year period³	Begins when shares acquired by trust, as employee deemed to own at that time.	Begins when option exercised.
Employment benefit	Fair market value at exercise.	Fair market value at exercise, less amount paid by the employee.
Net effect	The entire benefit, including any value given at the date of grant, is taxed at 50% of marginal rates. Growth is taxed as a capital gain.	The amount of the exercise price is paid by the employee; only growth in value of underlying stock is taxed at 50% of marginal rates. No capital gains until exercise and shares acquired.
Adjusted cost base (ACB)	Lower ACB means: <ul style="list-style-type: none"> higher amounts taxable as capital gains, and subject to capital gains deduction; and smaller capital loss if stock price declines. 	Higher ACB means: <ul style="list-style-type: none"> more income is taxed as an employment benefit; and possibly higher capital loss, which cannot be claimed if no other capital gains.
Complexity	More complex because the trust makes formal trust documents and trustees necessary, in addition to stock option agreement.	Some, because of the stock option agreement.
Dividends (if any)	Received and taxed commencing with the placing of the shares in trust.	Delayed until employee owns shares.
Vesting period not met	The shares are returned to the company so the employee can receive a deduction for employment income already taxed.	No tax consequences to employee, because shares never were acquired.

³ Employees who acquire CCPC shares through the exercise of stock options may be entitled to a 50% deduction in the taxable benefit, provided they hold the shares for two years after exercise. There is no condition related to the value of the exercise price paid as there is with regular stock options.

Buyouts – effect of recent changes

Additional implications of the new rules (allowing a deduction only by the company or the employee, but not both), are highlighted in the following situation. A purchaser has valued a company, with a million shares outstanding at \$1 million, based on the income-earning potential of the company. Unexercised stock options for 100,000 shares are held.

Until the budget change, the company could purchase or cancel these stock options for \$100,000. If it was able to take an income tax deduction, it would have been left with \$916,500 in cash (assuming a 16.5% tax rate). The employee should also be eligible for the 50% stock option deduction, assuming the options otherwise qualified for the deduction.

Since the budget changes, an employee will have to exercise and receive shares in the context of a transaction or, if their options are cashed-out, the employer will have to forgo a deduction in order for the employee to receive a 50% deduction. Because many option programs in Canadian private companies depend on the availability of an employer deduction for a cash-out in a transaction, it may be worth considering whether a restricted stock plan may better suit the objectives of both the company and its employees.

Conclusion

Companies should review how they deliver equity compensation to employees. They should consider providing a mechanism that lets employees cash out if necessary, and also whether recently proposed changes in the tax rules require changing the way they deliver equity compensation.

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See “How to get *Wealth and Tax Matters*,” on page 33.

What's your business worth today?



As an entrepreneur, busy with the day-to-day demands of owning and managing a business, you may not have given much thought to exactly what the ultimate goal of your venture is. One of the most common and financially rewarding exit strategies for an entrepreneur is the sale of the business to a large strategic buyer or a private equity group.

The first question most owner/managers ask when considering a divestiture is: What am I really worth?

General Valuation Mechanics

Numerous methodologies, including discounted cash flow, capitalized cash flow, and liquidation value are used for private company valuation. Each is highly subjective, and the appropriate methodology varies depending on its purpose.

Valuations performed for tax, financial reporting purposes or transaction purposes can all result in different conclusions about the company's worth. In the context of a divestiture, most Canadian private companies are valued based on a multiple of earnings before income tax and depreciation (EBITDA) or a multiple of a financial metric (free cash flow, net assets, revenue, etc.) more suitable to a particular industry.

A multiple is applied to a "normalized" metric. This means that unusual one-

time events or cyclical anomalies are added/deducted from the benchmark metric as necessary. Above-market management salaries, often common in owner-managed businesses, for example, are typically added back to financial results. Conversely, a one-time windfall sale due to a non-recurring event likely would be deducted from financial results.

This sounds like a fairly simple calculation, but identifying what multiple should be chosen is more an art than it is a science, because no firm rules determine where your firm will fall within an acceptable range of earnings multiples. An average multiple for your sector might be 5x EBITDA, but the range of typical multiples can be as broad as 2x to 10x.

Among the factors—all out of your control—that determine what multiple is most appropriate are:

- recent transaction multiples for similar companies;
- public multiples of strategic acquirers;
- synergies with acquirers;

- industry dynamics; and
- general macroeconomic conditions, especially credit market conditions.

However, other factors—and these are within your control—will also affect how high a multiple your company can command. No matter the state of your venture, you should understand each of these value drivers. They include:

- high profit margins;
- captive recurring customer base;
- strong brand;
- niche market expertise;
- strong contracts and relationships;
- sales channel expertise; and
- scalability of business model.

As an entrepreneur, you should identify the factors that can heighten your company's value and focus on developing them. Overall, enterprises with one or more of these value drivers in the right macro-economic environment can command premium valuations.

Earnings multiples today

So, what exactly is a premium or average valuation? The answer depends on when you ask. During the 2008 credit crisis, for example, an absence of active buyers and comparable deal metrics meant that

some Canadian private companies were forced to accept less than desirable valuations or, if the need to sell was not pressing, simply put divestiture plans on hold.

Today, the Canadian middle market¹ has a slow but steady volume of transactions. Multiples are in line with 2005-2006 averages. During the third quarter of 2010, multiples on announced middle market merger and acquisition transactions ranged from 5.2x – 19.03x while average revenue multiples ranged from 0.53x – 1.74x. As depicted in the accompanying table, multiples varied widely by sector.

		Multiple	
		Average EBITDA	Average revenue
Sector	Consumer discretionary	11.4	0.58
	Consumer durables	5.2	0.72
	Energy	19.03	12.43
	Financials	9.24	1.24
	Healthcare	18.75	0.53
	Industrials	4.49	0.67
	Information technology	12.59	1.74
	Materials	8.17	0.81

Source: Capital IQ, PwC Analysis

The following table shows some key middle market deals during the third quarter of 2010.

The fact that average multiples have rebounded should be taken with a grain of salt. Remember the other side of this equation—a multiple must be applied to an appropriate financial metric, such as earnings or revenue. Without a healthy financial metric, no matter the multiple, the all-in transaction proceeds will be low. On the flip side, with a high financial metric, even a lower than desired multiple can result in impressive transaction proceeds.

Observations

The PwC Corporate Finance practice has extensive experience providing guidance on private company valuation in an M&A context. Our view has always been that, except for extremely unusual economic circumstances, there will always be a buyer for a strong Canadian private company. It remains up to you, the entrepreneur, to ensure that your business has value drivers. This, more than anything, will determine just how valuable your venture can be.

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¹ Middle-market transactions are defined as deals with a total enterprise value < \$250 million. A Canadian transaction was defined as any M&A deal involving at least one Canadian entity.

Some key middle market deals in 2010 Q3

Announced date (m/d/2010)	Target	Total transaction value (\$millions)	Buyer
08/12	Maidstone Bakeries	\$454.68	ARYZTA AG (ISE:YZA)
09/17	Continental Minerals Corp. (TSXV:KMK)	\$417.85	Jinchuan Group Ltd.
10/05	Atria Networks LP	\$417.77	Rogers Communications Inc. (TSX:RCI.B)
10/04	GCAN Insurance Company	\$410.52	Royal & Sun Alliance Insurance Company Of Canada
10/18	Antares Minerals Inc. (TSXV:ANM)	\$403.63	First Quantum Minerals Ltd. (TSX:FM)
06/14	Petro-Canada Netherlands B.V.	\$403.17	Dana Petroleum (E&P) Limited
01/11	Grant Forest Products, Inc., OSB and Associated Facility at Earlton, Allendale and Clarendon	\$400.00	Georgia-Pacific LLC
05/16	Seacliff Construction Corp.	\$372.70	Churchill Corp. (TSX:CUQ)
01/20	Dvoynoye Gold Deposit and Vodorzdelnaya Gold Property	\$367.96	Kinross Gold Corporation (NYSE:KGC)
08/04	Korea National Oil Corporation, BlackGold Oilsands Project	\$367.10	Harvest Operations Corp.
06/09	PMA Companies, Inc.	\$365.79	Old Republic International Corp. (NYSE:ORI)
04/30	37,000 net acres of land in the Eagle Ford shale play in Texas	\$360.00	Talisman Energy Inc. (TSX:TLM)
09/01	Mass Financial Corp. (OTCPK:MFC.A.F)	\$353.18	Terra Nova Royalty Corporation (NYSE:TTT)
08/12	Suncor Energy, Natural Gas Assets in Wildcat Hills Region	\$351.78	Direct Energy Marketing Limited
03/08	RathGibson LLC	\$345.51	Eaton Vance Management; Blackrock Financial Management Inc.; Wayzata Investment Partners LLC; CI Investments Inc.
01/27	Result Energy Inc.	\$340.29	PetroBakken Energy Ltd. (TSX:PBN)
07/11	Monterey Exploration Ltd.	\$338.04	Pengrowth Corporation
07/06	Sentinelle Medical, Inc.	\$335.00	Hologic Inc. (NasdaqGS:HOLX)
01/04	Concert Industries, Ltd.	\$315.09	PH Glatfelter Co. (NYSE:GLT)
01/27	Athabasca Potash Inc.	\$313.81	BHP Billiton Diamonds Inc.
05/27	Logibec Groupe Informatique Ltee	\$250.34	OMERS Private Equity; Societe Generale de Financement du Quebec
08/08	Menu Foods Limited	\$227.20	Simmons Pet Food, Inc.
08/28	AuEx Ventures, Inc. (TSX:XAU)	\$226.24	Fronteer Gold Inc (TSX:FRG)
03/10	Dakota Growers Pasta Company, Inc.	\$225.73	Agricore United
09/21	Pristine Power, Inc. (TSX:PPX)	\$221.98	Fort Chicago Energy Partners LP (TSX:FCE.UN)
03/29	Canpages, Inc.	\$220.70	YPG Holdings Inc.
01/28	Siperian, Inc.	\$200.08	Informatica Corporation (NasdaqGS:INFA)
04/09	QNX Software Systems International Corporation	\$200.00	Research In Motion Limited (TSX:RIM)
03/15	Sport Supply Group, Inc	\$185.99	Andell Holdings, LLC; ONCAP
10/10	Talisman Energy Inc., 37,000 Net Acres in Eagle Ford Shale Formation in Texas	\$180.00	Statoil ASA (OB:STL)
08/09	Aecon Mining	\$175.32	Aecon Group Inc. (TSX:ARE)
05/28	SAVVIS Canada, Inc.	\$169.13	SAVVIS Inc. (NasdaqGS:SVVS)
05/14	Taylor Logistics, LLC	\$147.00	Gibson Energy ULC
02/16	Lions Gate Entertainment Corp. (NYSE:LGF)	\$126.18	Icahn Associates Corp.; High River LP
02/18	Lilydale Co-operative Limited	\$124.57	Sofina Foods Inc.
06/30	West 49 Inc.	\$93.30	Billabong International Ltd. (ASX:BBG)
04/30	Corus Entertainment Inc., Quebec Radio Stations	\$79.00	Cogeco Inc. (TSX:CGO)

Piecing the puzzle together

Managing your private foundation's assets after March 3, 2010



These questions and answers address key new issues facing private foundations.

Is it business as usual for your private foundation?

Managing your Canadian private foundation has become more complex—or maybe less—in light of the proposed amendments to registered charity tax rules that the federal government announced on March 4, 2010. This article explores the proposed changes¹ and their varied effects on your private foundation.

What will the private foundation's disbursement obligation look like after March 3, 2010?

The 2010 federal budget announced the government's intention to overhaul the disbursement quota rules. The disbursement quota is the minimum amount that registered charity must spend on its own charitable activities and/or on gifts to qualified donees in respect of a particular taxation period.

The proposed tax amendments eliminate the component of the current disbursement quota rule that requires charities to spend 80% of the previous year's tax-receipted donations on those charitable programs or gifts in the current year. However, charities are still required to disburse annually at least 3.5% of the value of their assets² that

are not used directly in their charitable programs or in their administration. Once enacted, these new and amended rules will take effect for fiscal years that end after March 3, 2010.

For your private foundation, disbursement quota reform will simplify the calculation of minimum spending requirements. In many cases, the changes will reduce the minimum spending requirements and relax the timelines associated with a foundation's spending requirements. This will allow the directors or trustees to manage the foundation's income and capital in a manner that supports the foundation's charitable goals without the immediate spending obligations of the past.

The changes support the desire of charities to focus on building capacity and, when appropriate, to accumulate assets in support of their charitable mandates.

How does the private foundation manage its enduring property assets received before March 4, 2010?

If your foundation received a gift of enduring property (e.g., 10-year plus gifts) before March 4, 2010, it is obliged to maintain the capital of that gift (i.e.,

¹ Pursuant to technical amendments announced August 27, 2010 and as tabled in Bill C-47 on September 28, 2010.

² The current tax provisions provide for an exemption from the 3.5% disbursement rule for charities with \$25,000 or less in assets that are not used in their charitable programs or in their administration. Under the proposed tax amendments, the asset exemption threshold for private foundations will remain at \$25,000.

asset or assets substituted for the original asset) for the period stated by the donor in the original deed of gift (generally, at least 10 years from the date the gift was made by the donor and received by the foundation). These are commonly referred to as “10-year plus gifts” or “gifts of enduring property.”

With the planned elimination of the 80% disbursement rule, the concept of enduring property will disappear. Under the proposed simplified disbursement quota regime, when the capital of enduring property gifts is eventually spent after the 10-year holding period expires, the value spent no longer will be factored into the foundation’s annual minimum spending requirements for that year. Any unspent enduring property, including the appreciated value of the assets, will continue to be subject to the remaining holding period and its value will continue to be factored into the 3.5% disbursement quota each year until the assets are spent.

Future gifts to the foundation no longer will have to be specifically characterized as 10-year enduring property gifts to avoid the pre-March 4, 2010 requirement to spend the capital of the gift immediately. A donor will be free to contribute to the foundation with or without restrictions. In particular, a donor can require, at the time the donation is made, that the foundation not spend the capital of the gift for a specified period.

What is the foundation’s fiduciary responsibility with respect to enduring property gifts received before March 4, 2010?

For enduring property received before March 4, 2010, the foundation will still have fiduciary responsibility to hold the capital in whole until the holding period expires and in accordance with the terms of the original pre-March 4, 2010 gift.

If capital of an enduring property is spent before its holding period expires, the foundation should consult with the foundation’s legal counsel to assess the implications of any breach of trust issues.

What does the foundation do with its capital gains pool?

Some foundations have been tracking the realized capital gains on the sale of enduring property assets since March 23, 2004, for purposes of building up their capital gains pools. The proposed disbursement quota rules do away with the concept of the capital gains pool, and the balance in it becomes irrelevant.

What happens to the foundation’s disbursement excess balances?

A foundation generates a disbursement excess if it expends more than its disbursement quota requirement for a particular taxation year on its charitable activities and/or gifts to qualified donees. The foundation can use this disbursement excess to reduce or eliminate a disbursement shortfall of

the preceding taxation year or to help meet its disbursement requirements for any of the following five taxation years.

Any disbursement excess that a foundation carries at March 4, 2010, can still be used after that date; the planned changes to the disbursement quota do not reset them to zero.

How will your foundation’s planning change?

Your foundation, beyond managing assets it owns now, might consider how best to interact with its donors in respect of future gifts. It can strike a healthy balance between the need for capital preservation through endowed gifts and the desire to use its unrestricted funds, including income, for the purpose of making charitable grants and carrying out its charitable activities.

With proper planning, the pieces of the puzzle can come together to achieve your foundation’s philanthropic goals.

Stay tuned to see if the proposed amendments are enacted into law as anticipated. If not, the planning suggestions in this article may have to be reconsidered.

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See “How to get *Wealth and Tax Matters*,” on page 33.

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