

Private Company Services
High Net Worth

Wealth and Tax Matters

for individuals and private companies

Winter 2009

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Editorial

The current economic "situation" (several stronger words suggest themselves) has overshadowed even the weather as a topic of conversation and consternation. Dramatic changes have affected businesses, individuals and trusts in many ways, but could present planning opportunities. For example, an estate freeze put into effect a few years ago may have frozen an asset at what is now too high a value, and a refreeze could be in order, to limit the value of the estate. Acting now could pay off later.

This being the winter edition of *Wealth and Tax Matters*, freezes are a particularly apt topic, and are discussed in two articles. As in the previous edition, we start off by exploring trusts, this time alter-ego and testamentary. The next topic deals with tax aspects of the sale of a business. The proceeds of such a sale are one possible source of funds for

investment in a private company or for setting up a private foundation, which are the next two topics. For a business that is not sold, the next contribution, "When Business Becomes a Family Matter," deals with the ever-important topic of succession planning. Finally, after discussing traditional and flexible freezes, we consider the basics of taxable and non-taxable benefits, which can have some special wrinkles when the recipient is a shareholder.

The economy prompted a number of measures in the January 27, 2009 federal budget. Any implications have been noted.

We're always interested in your comments and ideas for topics. Simply contact either of us, the authors of the articles, or any of the professionals on the inside back cover.



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Trust basics part 4

Estate planning with alter ego and joint spousal trusts



The autumn 2008 edition of *Wealth and Tax Matters* discussed what a trust is, how to share your wealth with family members using a family trust, and why it is important for individuals in a trust's three key roles (settlor, trustee, beneficiary) to understand what they can and cannot do to avoid the unpleasant tax consequences of certain rules in the *Income Tax Act*.

This fourth article on trusts explores two types of trusts commonly used by seniors for estate planning: the alter ego trust and the joint spousal trust. By definition, these are inter vivos trusts because they are created during an individual's lifetime. Before getting into how these trusts work, it will be helpful to outline what they have to offer.

Why consider an alter ego trust, a joint spousal trust, or both?

Alter ego trust and joint spousal trusts can be beneficial in several ways:

- When a person dies, the assets he or she owns at the time of death fall into his or her estate. Depending on the nature of the assets, the estate can become complicated for the executors to manage. By transferring certain assets into an alter ego trust or a joint spousal trust before death, these assets would be excluded from the estate, making the estate easier to administer. Going forward, the assets are managed by the trustees

appointed by the transferor (the settlor) under the terms of the trust indenture.

- When a will is probated, probate fees for which the estate is liable are based on a percentage of the fair market value of the assets held by the person on the day of death that pass to the estate. The table illustrates probate fees for all Canadian provinces and territories. Assets transferred to an alter ego trust or a joint spousal trust do not form part of the estate, so no probate fees are payable on them. This also avoids delay in distributing the assets, because probating an estate is sometimes lengthy.
- When using a trust, a person's wishes are implemented under the terms of the trust indenture rather than his or her will. In general, it is more difficult for dependants of the deceased to challenge the validity of gifts made through a trust than those made under a will. Therefore, a trust can provide somewhat

greater certainty that the persons receiving the benefits are indeed the deceased's intended recipients. It can also preserve the confidentiality of the person's wishes, because a trust indenture, unlike a probated will, is not a public document. For these reasons, alter ego and joint spousal trusts are often used as substitutes for wills.

- These trusts can also be used as alternatives to a Power of Attorney. Trustees can be appointed in the trust indenture to manage the trust assets should the person become incapacitated.
- Although the objectives discussed above can be achieved with a family trust, the transfer of properties into a family trust may give rise to immediate income tax consequences if they have appreciated in value. The advantage of an alter ego trust or a joint spousal trust is the ability to transfer assets to the trust at the settlor's cost. Any increase in value over the settlor's cost is taxed on the earlier of an actual disposition by the trust and a deemed disposition by the trust. The trust is deemed to have disposed of its assets at fair market value on the day of death of

the settlor in the case of an alter ego trust, or of the survivor of the settlor and the spouse in the case of a joint spousal trust. The 21-year deemed disposition (also known as the 21-year rule, discussed in the autumn 2008 edition in "Trust basics part 1: Removing the mystery") does not apply to an alter ego or joint spousal trust until 21 years after the deemed disposition.

Alter ego and joint spousal trusts have lots to offer, but some downsides must be taken into account.

- Income, to the extent it can be retained and taxed in the trust, is taxed at the highest personal marginal tax rate on every dollar of income.
- Certain assets, such as registered retirement savings plans and registered retirement income funds, cannot be transferred to the trusts on a rollover basis.
- When legal title to real property is transferred from the settlor to these trusts, provincial and municipal land transfer tax could be triggered, depending on the location of the property.

- The trust has no access to the capital gains deduction in respect of qualified small business corporation shares held at the time of the deemed disposition occurring on the death of the settlor or survivor.
- Charitable gifting by these trusts requires more planning.

How does an alter ego trust or a joint spousal trust work?

For a trust to qualify as an alter ego trust, the settlor must be at least 65 years old when he or she settles the trust. Under the terms of the indenture, the settlor, while alive, must be entitled to receive all of the income of the trust. No person other than the settlor may receive or obtain the use of any of the income or capital of the trust while the settlor is living. In other words, under the terms of the indenture, other beneficiaries cannot receive income and capital of the trust until after the settlor's death.

As the name suggests, a joint spousal trust is set up for the benefit of both the settlor and his or her spouse or common-law partner. As with an alter ego trust, for a trust to qualify as a

joint spousal trust, the settlor must be at least 65 years old at the time the trust is created. The settlor and/or the spouse must be entitled to receive all of the income of the trust while either the settlor or the spouse is alive. No person other than the settlor and the spouse may receive or obtain the use of any of the income or capital of the trust while one of them is still living.

In most cases, the property of an alter ego trust or a joint spousal trust can revert to the settlor. Accordingly, income, losses, capital gains and capital losses are attributed to and taxed in the settlor's tax return rather than in the trust's return.

To ensure that post-mortem planning can be undertaken, the alter ego or joint spousal trust indenture should provide for the continued existence of the trust beyond the death of the settlor or survivor, if appropriate. The trust indenture will contain instructions for the distribution of the trust property following the death of the settlor or survivor to the beneficiaries including the timing and nature of distributions. These instructions should contemplate the post-mortem planning.

While the use of inter vivos trusts for estate planning can achieve many objectives, the same can be said

about the use of testamentary trusts (trusts that come into existence as a consequence of death – a topic for a future article).

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Probate fees (for estates over \$50,000)¹

	Fee		
Alberta	\$200 to \$400		
British Columbia	\$358	+	1.4% of portion over \$50,000
Manitoba	\$70	+	0.7% of portion over \$10,000
New Brunswick	0.5% of estate value		
Newfoundland and Labrador	\$90	+	0.5% of portion over \$1,000
Northwest Territories	\$200 to \$400		
Nova Scotia	\$876	+	1.479% of portion over \$100,000
Nunavut	\$200 to \$400		
Ontario	\$250	+	1.5% of portion over \$50,000
Prince Edward Island	\$400	+	0.4% of portion over \$100,000
Quebec	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.		
Saskatchewan	0.7% of the estate value		
Yukon	\$140		

1. This information is intended to provide only a general indication of probate fees. Other rates may apply to estates with values of \$50,000 or less.

Trust basics part 5

Where there's a *will*, there's a way



This article discusses advanced tax planning in wills by use of testamentary trusts. The previous issue of *Wealth and Tax Matters* discussed the basics of inter vivos discretionary trust planning. In this issue, the article by Angela Ross and Nicholaos Karkas discusses the concept of an estate freeze, while another, by Jean-François Drouin and Gaétan Roy, explains the flexible estate freeze of your wealth in favour of an inter vivos discretionary family trust.

As these articles point out, inter vivos trust planning offers many benefits by providing unparalleled flexibility in the areas of estate planning, succession planning, income splitting, creditor protection, and movement of assets in related business groups. Advanced tax-planned wills, through the use of testamentary trusts, can provide many of those same benefits, plus the additional rewards of income splitting and tax saving, through use of the testamentary trust's own tax return.

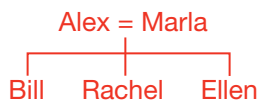
As many of us can attest, the death of a loved one is the most traumatic event that a family can experience. No amount of tax and financial planning can eliminate the emotional pain. However, timely and appropriate will planning can certainly mitigate the financial harm to the family, and even turn a death into a tax-planning positive. One can view this planning as honouring the memory of the deceased by ensuring that the surviving family

members are placed in the most advantageous tax planning position possible.

To understand the tax benefit, consider the basics of trust taxation. An inter vivos trust is taxed at the top personal marginal rate of tax on each dollar of income that it retains. In contrast, a testamentary trust is entitled to the full set of tax rates and brackets, just like an individual. This means that income taxed in the testamentary trust itself can provide a tax saving by virtue of use of the trust's lower rates and brackets. For instance, in Ontario the availability of the lower rates and brackets provides a permanent annual tax saving of approximately \$16,100 on \$126,000 of yearly income for 2008. Actual savings vary depending on provincial or territorial tax rates and the amount of income in the trust.

To illustrate some of the tax planning possible via properly drafted wills, consider the case of Alex and Marla

Planner, and their three adult children, Bill, Rachel and Ellen. Bill, the eldest, had suffered a brain injury in a car accident some 10 years ago, and while he has a relatively simple job that gives him satisfaction, Alex and Marla worry that Bill would have difficulty managing any material amount of money.



Alex and Marla have done a flexible estate freeze of their share interest in their family company (Planner Inc.) in favour of an inter vivos discretionary family trust in which Alex, Marla and the three children are income and capital beneficiaries. Care was taken in creating and structuring the trust to avoid the provisions of subsection 75(2) of the *Income Tax Act*. As a result of this freeze both Alex and Marla own fixed-value freeze preferred shares worth \$3.5 million, and all the new common shares of Planner Inc. are owned by the inter vivos trust. Planner Inc. has been successful in the past, and as a result of past accrued bonuses to Alex and Marla (which had been done to “bonus down” to the annual small business limit), each of Alex and Marla also have tax-paid shareholder loan accounts owing to them from Planner Inc. of \$6 million, as well as substantial personal term deposits. Since the freeze, Planner Inc.

has continued to be successful, and the common shares owned by the trust are worth \$1.5 million.

Unfortunately, Alex has recently received very bad news: he has a terminal illness, and the prognosis gives him only six months to live. He wants to ensure that Marla is well taken care of financially after his passing, and he and Marla want to treat their children equally from an inheritance perspective.

What could an advanced tax-planned will accomplish, using testamentary trusts? Alex has indicated that he wants to maximize the income-splitting benefits provided by these trusts. We have suggested to Alex that his will provide for creation of the following testamentary trusts on his passing:

- Three spousal trusts will be created, each to receive one-third of any “appreciated” property (i.e., property with inherent capital gains at death). This provides the necessary “tax rollover” and avoids taxation on his death.

Bill (or a trust for Bill) will be the residual beneficiary of one spousal trust, Rachel (or a trust for Rachel) on another, and Ellen (or a trust for Ellen) on the last. In all cases, during her life Marla is entitled to all income of each spousal trust, and has access to as much capital of the trusts as Alex cares to provide for in his will.

- Three discretionary testamentary family trusts will be created, each to receive one-third of all his other assets that do not have inherent capital gains at his death, such as his tax-paid shareholder loan account from Planner Inc. and his term deposits.

In the “Bill trust,” Bill and Marla are the beneficiaries. Similarly, in the “Rachel trust,” Rachel, her spouse and children and Marla are the beneficiaries, while in the “Ellen trust,” Ellen, her spouse and children and Marla are the beneficiaries.

Except for the Bill trust, Marla is the trustee during her life, and on her passing the relevant child becomes the trustee of their own trust.

However, because of Bill’s problems handling money, when Marla passes away Rachel and Ellen become co-trustees of Bill’s trust, to ensure that Bill’s inheritance is prudently managed in his best interests. Bill’s trust also has special beneficiary provisions to protect any offspring he might someday have, and, if he does not, creating giftovers of the remaining trust property to his siblings in the event of his death.

- On Marla’s passing, the property in each spousal trust passes to the discretionary testamentary family trust for that same child.

Marla's will is a mirror-image of Alex's, in the event that she predeceases him — a remote possibility that nevertheless must be addressed appropriately. Her will also provides that if she survives Alex, as expected, on her passing her property flows equally to three discretionary testamentary family trusts similar to those described above in Alex's will.

The plan is that the rates and brackets available to the three spousal trusts will be used to annually redeem a portion of Alex's freeze preferred shares in Planner Inc., and have the amounts taxed at favourable marginal rates, with the hope that all of Alex's shares are so redeemed in the spousal trusts during Marla's lifetime. They also might consider making Alex's tax-paid shareholder loan account with Planner Inc. interest bearing after his passing to provide a steady stream of income for the three discretionary family trusts, thus maximizing the income splitting potential.

Alex always hated paying income tax, and derives a considerable amount of comfort from the knowledge that after his passing, his own personal tax return will be replaced by six testamentary trust returns, each of which can provide an annual tax saving to his family of \$16,100. He is made even happier when told that each of the discretionary

family trusts for his children can allocate income to his child, or grandchildren, thus also accessing those individuals' marginal rates and brackets for substantial additional annual savings. He is also comforted knowing that Bill's inheritance will be prudently managed for Bill's benefit by his two sisters after Marla has passed.

We had suggested to Alex, that if he truly believed his prognosis was without hope, that he consider causing the existing family trust (of which he is a trustee) to distribute the common shares of Planner Inc. back to himself during his life (on a rollover basis), so that these shares could then be left to the three spousal trusts on his death. Because of the availability of annual rates and brackets for the testamentary trusts, it might be advantageous going forward to have the common shares held in the three spousal trusts rather than the inter vivos family trust. However, Alex remained hopeful that he could beat his illness, so he chose not to take this irreversible action.

Clearly, the testamentary trusts will provide significant income-splitting benefit, much greater than possible with inter vivos trust planning, and will also ensure appropriate levels of financial protection for Marla during her life, and Bill during his, all the while setting all of his children up in strong

tax planning situations after Marla has died. The income-splitting benefits likely will be fully realized, because Alex had a sizeable estate, with enough income to use all of the lower rates and brackets made available by the planning.

However, even people who are not wealthy might seriously consider setting up discretionary testamentary family trusts in their wills for each of their children, and settling relatively nominal sums (such as \$1,000) in those trusts. If their children were involved in operating their own family businesses, this would enable each child to subsequently do an estate freeze of their own businesses using the testamentary trust rather than having to use an inter vivos trust, thereby providing the superior income-splitting opportunities. In this way, parents of even modest means can provide a significant tax opportunity to any of their offspring who happen to own their own companies.

All of these benefits can be achieved by simply having an appropriately drafted will, something each of us should consider mandatory.

Have you reviewed yours lately?

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Relinquishing U.S. citizenship Harder than you think!



Many U.S. citizens (and dual citizens) and long-term permanent residents (i.e., certain green card holders) living in Canada are surprised to discover that they are subject to U.S. income, estate and gift tax, as well as Canadian income tax. In addition to creating ongoing U.S. tax compliance obligations, this may result in significant extra tax down the road. The top U.S. estate tax rate, for instance, is 45% on the fair market value of a U.S. citizen's worldwide estate.

(A U.S. spouse or U.S. child in a family also faces particular U.S. tax implications. These were addressed in previous editions of this publication.)

If you are a U.S. citizen, one strategy for dealing with your U.S. tax exposure is to relinquish that citizenship. However, before doing so, it is prudent to consider the implications of the U.S. expatriation rules.

The current rules

New U.S. expatriation rules were passed into law in 2008. The new law applies to any U.S. citizen who relinquishes citizenship after June 16, 2008. Individuals are not subject to these new rules if they have:

- a net worth less than \$2 million on the date of expatriation;
- an average net federal income tax liability for the five preceding years ending before the date of expatriation of less than \$145,000; and

- complied with all U.S. federal tax obligations for the five years before expatriation.

Exception for dual citizens

An additional exception is provided for certain dual citizens. To qualify, an individual must:

- have acquired both citizenships at birth;
- be a resident of Canada at the date of expatriation and continue to be a citizen and taxed as a resident of Canada; and
- have resided in the U.S. for fewer than 10 of the 15 years in the period that ends with the year during which expatriation occurs.

This is good news for those many Canadians who find themselves U.S. citizens even though they have never spent any significant time in the U.S. For example, this exception should

Observation

The worldwide property of the expatriate is deemed to be disposed of under the exit tax. This may include property such as principal residences, vacation homes, and rental properties in Canada. General stock investments and interests in Canadian private companies would also be subject to this tax.

exempt many Canadians who acquired U.S. citizenship because they:

- were born in the U.S. to Canadian-citizen parents, but returned to live in Canada when they were young children and have never returned to the U.S.; or
- were born in Canada to U.S.-citizen parent and have never lived in the U.S.

To take advantage of this exception, the dual citizen must still be able to certify that he or she has met all U.S. federal tax requirements for the five years prior to expatriation. If this is not the case, the dual citizen must take steps to bring past filings up-to-date. This may require some kind of negotiated settlement with the Internal Revenue Service if the individual has significant unpaid U.S. tax or is facing penalties for failure to provide certain information returns.

What happens if you are not exempt?

If you are not exempt from the new rules you will be subject to special income and gift tax provisions. The provisions are commonly referred to as the “exit tax.”

Mark-to-market tax

All capital property of the expatriate is deemed to have been sold for fair market value on the day before the expatriation date. Any net gain on the deemed sale is included in income during the year of expatriation but only if the gain exceeds \$626,000.

The expatriate can elect to defer the exit tax. If so, security will have to be posted with the Internal Revenue Service and interest will be charged.

Treatment of special property

Certain deferred plans are handled differently. Instead of a deemed disposition, either the future value of the interest is immediately included in the income or a 30% withholding tax is levied at the time payments are actually received by the expatriate. These special properties may include:

- Canadian and foreign pension plans;
- RRSPs;
- IRAs;
- qualified tuition, education and health savings accounts; and
- certain trust interests.

The \$626,000 exemption applies only to gains derived from capital property and does not reduce income inclusions resulting from treatment of special property.

Tax on future gifts

If the expatriate makes a gift to a U.S. person, the recipient (not the expatriate donor) will be subject to U.S. gift tax based on the value of the gift. The U.S. gift tax rates are the same as the U.S. estate tax rates, the top rate being 45%. This gift tax applies to gifts made during lifetime as well as to gifts made under the expatriate’s will. As a result, expatriation may not be a viable option if the individual’s family members are U.S. persons, because it will effectively subject the expatriate’s estate to U.S. tax.

The bottom line

Although relinquishing U.S. citizenship may be an alternative to dealing with certain U.S. tax obligations, the expatriate must do a thorough analysis of his or her worldwide assets before taking any steps to renounce citizenship.

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Selling your business

A tax primer



If you own shares of a business and are thinking about reducing your involvement in the business or exiting altogether, read on.

For Canadian tax purposes, shares of non-farm related businesses generally cannot be passed tax-deferred from parents to children or grandchildren. Fortunately, a variety of options exist to reduce the tax effect of the transfer to the next generation. Nevertheless, in many instances, rather than keeping it in the family, the decision is made to sell all or part of the business to a third party and/or employee group.

For incorporated businesses, two conventional options for the sale are:

- by the owner-manager of the corporation's shares; and
- by the corporation of its assets.

For Canadian-controlled private corporations (CCPCs) engaged in an active business, the shareholders often prefer the first approach — selling their shares of the CCPC — rather than having the CCPC sell its assets and then distribute the after-tax proceeds to the owner-manager. Reasons include:

- the capital gains deduction¹ for shares of a qualified small business corporation (QSBC) being available to shelter some or all of the personal capital gains tax arising from the sale;
- being able to avoid or reduce the historical tax costs associated with the distribution of corporately taxed income in excess of the small business limit.

As well, effective for dispositions that occur after February 27, 2000, individuals have also been able to defer the capital gains tax associated with proceeds from the sale of shares of certain CCPCs reinvested within a specified period.

In contrast, purchasers tend to prefer the second approach, at least from an income tax perspective, especially when significant depreciable assets and/or goodwill exist. In the case of an asset purchase, the availability of additional tax deductions or credits reduces the purchaser's after-tax cost of the acquisition and sometimes leads to the offer of a higher purchase price for an asset sale than for a share sale.

1. Assuming a top marginal tax personal tax rate of 23% for capital gains, up to approximately \$173,000 of tax savings are available per shareholder by fully using his or her lifetime capital gains deduction for QSBC shares.

The table to the right summarizes the estimated corporate tax payable by a CCPC vendor on a sale of certain asset types and the estimated present value of the incremental tax deductions associated with the purchase of certain asset types by a taxable purchaser.

Decreases to general corporate tax rates, coupled with fairly recent changes to the personal taxation of certain dividends, have significantly reduced the total corporate and personal tax liabilities associated with an asset sale. In many cases these developments also provide significant tax deferral opportunities.

Key variables in a quantitative analysis of the after-tax proceeds to the vendor often include:

- the amount of tax shelter available to the vending shareholder or corporation;
- the level of the corporation's safe income on hand (SIOH) — commonly referred to as the corporation's tax-retained earnings; and
- various other tax attributes.

		Estimated corporate tax payable ¹ by CCPC vendor (assuming NIL cost base)	Estimated present value ³ of incremental tax shield for taxable purchaser ¹
Asset type	Inventory	33.00% ²	33.00% (assuming sold in same year)
	Machinery and equipment		25.09% (assuming declining balance)
	Goodwill	16.50% ²	11.55% (using a 75% inclusion rate)
	Shares (capital gains rate)	24.33%	Nil

1. Using currently legislated federal and Ontario corporate tax rates for calendar 2009.
2. Corporate tax rate based on 100% of income taxed at the general corporate rate of 33.00%.
3. Using an after-tax discount rate of 8%.

Tests for qualified small business corporation shares	
Test for the shareholder:	Shares generally must be held for at least two years (unless certain conditions are met).
Test for the corporation:	The corporation must be a CCPC and: <ul style="list-style-type: none"> • have 90% or more of the fair market value (FMV) of its assets used in an “active business” carried on in Canada at the time of the disposition; and • have used more than 50% of the FMV of its assets in an active business carried on mainly in Canada, for the two-year period preceding the disposition.

For share sales, presale structuring is often undertaken to give owner-managers access to the capital gains deduction. However, for the owner-manager's shares to qualify

as “qualified small business corporation shares,” and its potential tax benefits, the corporation and the individual shareholder must both satisfy certain tests.

The tests for the corporation are asset-focused and do not directly include liabilities. Therefore, purification strategies are frequently used to reduce or eliminate “bad” assets by paying off liabilities or perhaps making distributions to shareholders.

Standard planning for a share sale generally involves a direct sale of the shares to the purchaser by the owner-manager and/or family trust. If a promissory note is received for a portion of the proceeds, it may be possible to pay the resulting capital gains tax liability over a five-year period. Alternatively, some proceeds might be received in the form of shares of the purchaser or a nominee corporation, which defers the capital gains tax liability until the new shares are sold. Sometimes, certain corporate tax pool balances (e.g., the capital dividend account and refundable dividend tax on hand) will be distributed to the shareholders before a sale.

Enhanced planning may include the use of a corporate vendor to take advantage of the corporation’s SIOH and defer personal taxes on all or a portion of the sale proceeds until removed from the corporation. To use a

corporation’s SIOH, shareholders who are selling make a tax-deferred transfer of all or a portion of their target shares to a holding company. Subsequently, the capital gain attributable to the target shares owned by the holding company can be reduced by using the tax deduction available for inter-corporate dividends.

The genesis of the SIOH tax deferral is the inter-corporate dividend tax deduction. Therefore, the greater the amount of SIOH associated with the vendor’s shares, the greater the opportunity to reduce the initial capital gains tax by structuring the sale through a Canadian corporation rather than having the sale made directly by an individual, who cannot claim the inter-corporate dividend deduction. Tax-deferred proceeds received by a holding company can be used for investment purposes. The income generated is generally subject to an effective tax rate comparable to that of an individual taxpayer earning the same income directly and paying tax at top marginal rates.

Additional strategies are available to help vendors significantly reduce or eliminate the total amount of tax

paid on a share sale, allowing the immediate tax savings to be available for investment purposes. In the right circumstances, even before considering the effect of SIOH and other tax balances, the overall tax paid on a sale of shares can be reduced to approximately 50% of the capital gains tax rate for the province of residence. And, in certain cases, with planning, immediate tax deferrals can be converted into permanent tax savings.

The options for reducing tax on the sale to third parties or the transfer to the next generation require careful analysis, but for owners of shares of a business who are ready to limit their involvement or exit the business entirely, the effort will be worthwhile.

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“Angels” investing in private companies

The opportunity of a lifetime?



In today’s troubled economic environment, private Canadian businesses have less access to growth capital than usual. As a result, high net worth individuals, sometimes referred to as “angel” investors, are becoming a common source of capital for small and medium-sized ventures.

If you are sufficiently capitalized, you could be the angel, and the current credit disequilibrium could be a once-in-a-lifetime investment opportunity. However, PricewaterhouseCoopers Corporate Finance recommends that before considering a private investment, you review your overall portfolio strategy and the typical investment process. Consulting with a financial adviser experienced in portfolio management is highly recommended.

In addition to the excitement and challenge of being involved in a growing venture, private investments offer potentially higher returns relative to public common stock or other investment products. Successful private investments could generate multiples of invested capital.

Angel investing, however, is not without pitfalls. Greater potential returns come with a greater risk of below average returns or complete loss. In most cases, you can expect illiquidity, with little or no cash flow, for at least five years. Without the proper mechanisms built into your investment, you may feel more like a “stuck-holder” than a stockholder.

Getting a deal done

How are private deals sourced?

There is no regulated market for private investments. Instead, investors often rely on corporate finance advisers, who participate in informal business networks, to present them with investment opportunities. It is also common to be approached by relatives or friends that need business

funding. Experienced investors are often members of an “angel group,” an established network of individuals who meet regularly with capital-seeking entrepreneurs. Members of angel groups can invest alone or by pooling their capital with other angels.

Remaining objective while reviewing investment opportunities is critical, regardless of any personal relationships. Every opportunity should involve all of the steps discussed in this article, at a minimum.

How are private investments valued?

A multitude of complex financial modeling techniques can be used to

arrive at a value. However, in some cases, angel investments are made at the early stages of the venture, and a great deal of educated guesswork is required to establish the probability of the venture’s success. For ventures already showing positive cash flow, it may be possible to assess value based on an earnings multiple of similar transactions. Motivation of the investee and investor are also key determinants of price.

Given the subjective nature of private company valuations, it is recommended that you engage a corporate finance adviser who has deal experience and access to direct market comparables in your investees industry. Value is not

static. As the dynamics of the market change, a trusted, informed adviser can also quickly re-evaluate a target company’s worth, enhancing your chances of buying at the best possible time and price.

How are private investments structured?

Historically, angel investors have purchased common shares with voting rights. However, the current disequilibrium between lenders and borrowers may permit you to invest using a broader variety and combination of structures. Some of the possibilities are shown in the table:

	Typical Cash Flow	Participant in Exit Proceeds	Voting Rights	Security Rank
Common shares	No regular cash flow. Dividends are unlikely to be declared.	Yes, pro rata based on diluted common share ownership.	Yes.	Lowest.
Debentures	Regular interest payments. (Rate determined by comparable debt instruments).	No.	No.	Highest.
Preferred shares	May include regular dividend.	Depends on the conversion rights of the preferred shares.	Unlikely, but you may have representation on the board of directors.	Above common shares, but below debentures.
Convertible debentures	Typically include interest at lower rate than non-convertible debentures.	Depends on the conversion rights of the convertible debenture.	No, but you may have representation on the board of directors.	Above common shares and preferred shares, but below debentures.
Warrants	None.	Yes: the owner of the warrants has a right to own more stock when a predetermined target is reached. Often added to debentures and preferred shares as deal sweeteners.	Only when converted into common stock. You may have board representation.	None.

What are the key steps in an investment process?

An investment process often begins with an informal review of the company's finances, operations and business plan. You will also meet with the entrepreneur to discuss his/her goals and objectives and your potential role in the venture. Based on this initial review, you can decide whether to more seriously pursue a deal.

After this initial review, there are four key stages in the investment process:

1) Term sheet: A term sheet is a document outlining the conditions under which you will invest in the company.

Before dedicating time and money to a deal process, both parties should agree on key terms, such as your role in the company, value, structure, timing, follow-on financing requirements, exit options and any conditions that must be met before you invest.

2) Due diligence: Due diligence is the process of gathering and analyzing information about the prospective investment.

A due diligence review will involve:

- conducting industry research to confirm or refute assumptions in the business plan, establishing the market value of assets and liabilities;

- reviewing historical financial statements, operational metrics and forecasts;
- assessing the competence and credibility of the management team; and
- examining legal documents.

Your business adviser will act as a liaison with the investee to coordinate the diligence process and guide you through your review. At this time, you may also want to engage the services of advisers specifically trained to perform due diligence.

3) Shareholders agreement:

A shareholders agreement is a critical document that will govern the relationship between the various stakeholders of the investee company. Ideally, business and legal advisers should guide you through various deal terms that can protect your interests. In addition to standard terms such as value, deal structure and share in profits, areas you should discuss with your adviser include:

- "Outs" – Under what circumstances will you want to release yourself from the obligation to complete a deal without consequences?

- Personal commitments – Will you be required to contribute anything to the venture other than financing?
- Pre-emptive rights – Do you want the right to maintain your fractional ownership by buying a proportional number of shares of any future stock issues?

- Intra-shareholder rights:

– Right of first refusal

Do you want the right to purchase shares from a shareholder prior to those shares being sold to a third party?

– Coat-tail or "tag along" provision

If the majority of shareholders want to sell their shares, will minority shareholders have the right to participate in a deal?

– Forced or "drag along" provisions

If the majority of shareholders agree to a deal, will a minority group of "holds outs" (e.g., 10%) be forced to accept the deal?

– Buy-out or "shotgun" provision

Should shareholders be protected from offering each other an unfair price for share buyouts? In a shotgun provision, if shareholder X declines an offer by shareholder Y to purchase shareholder X's shares, shareholder Y is permitted to buy shareholder X's shares under the same terms.

- Termination – Under what circumstances will your shareholders agreement be terminated?
- Liquidity rights – When and under what circumstances can you “force” a sale of the company or your shares?
- Board of directors – What are the duties and composition of the board of directors? How many seats will you have on the board and how else will your interests be represented?
- Requirements for follow-on financing – Under what circumstances will you be required to provide future financing, if at all?
- Reporting requirements – What kind of financial and operational reporting will be provided to you?
- Disability or death of shareholders – What will happen to the shareholdings of deceased or disabled shareholders?
- Liability – What is your maximum liability?

4) Subscription agreement: After completing diligence and a term sheet, your legal adviser will draft a more comprehensive subscription agreement detailing the precise terms of the investment, consistent with the term sheet and shareholders agreement.

You can make the process faster, easier and less costly by giving your lawyer a simple summary of your views on these matters so that an agreement can be drafted accordingly. Typically, a business adviser will work with legal counsel on your behalf.

What are my exit options?

While investment in a private company may provide you with some cash flow, via dividends or interest payments, your most significant payout is typically realized upon an exit, such as a sale of the business.

Most private investments have a time horizon of five to ten years, during which (if all goes well) the company could experience extreme growth.

Once the venture is stable, you will find yourself on the selling side of a deal and can sell your shares to a strategic company, a private equity firm or to the management team. If your company is large enough, the public markets are also an exit option, via an initial public offering.

Conclusion

Private investing is not for everyone. But, for the right investor, it can be an opportunity to turn your capital, business acumen and charisma into the achievement of a lifetime.

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To increase the chances of a successful private investment:

- **Review your portfolio.** Are you diversified and well-capitalized enough to take the risk?
- **Have a clear objective for your deal.** What is your ideal investment structure? What is your desired post-deal role in the business? What price are you willing to pay for the company? Are you willing to commit to follow-up financings? How long are you willing to hold on to your investment? Discuss these terms with your adviser.
- **Engage a corporate finance adviser.** The adviser will help you source the right deal, clarify your objectives and provide guidance on valuation and structure and lead you through the diligence and negotiation.
- **Engage a legal adviser.** The lawyer will draft three key documents — the term sheet, the subscription agreement and the shareholders agreement.

Private philanthropy

Creating a private foundation



Private philanthropy has been an integral part of Canada's legacy to the charitable community. A philanthropist who wishes to strategically organize his or her charitable giving has many options. This article explores one of them: the private foundation.

What is a charitable foundation?

A charitable foundation is an entity that is constituted and operated exclusively for charitable purposes. It may be created by trust or incorporation. A charitable foundation generally fulfills its charitable purposes through the disbursement of its assets to other qualified donees, which include other registered charities (see box).

Registered charities that are designated as private foundations are charitable foundations, in which:

- the majority of the directors or trustees do not deal at arm's length with each other or with the foundation's principal contributor(s); or
- a contributor to the foundation controls that foundation.

The designation of a charitable foundation as a private foundation does not preclude it from carrying out some of the charitable activities itself. Private foundations however, generally function as repositories and managers of funds. For the most part, the foundation's funds are generally granted to charitable organizations that carry on the charitable activities.

What is a private foundation?

A private foundation is a philanthropic vehicle that can provide great flexibility for charitable giving by you, your family, related corporate entities and any unrelated donor. Often, private foundations are created to promote family philanthropy, and therefore are commonly referred to as family foundations.

Qualified donees

In general, a qualified donee includes:

- registered Canadian charities, registered Canadian amateur athletic associations;
- most Canadian universities and colleges;
- some foreign universities, foreign charitable organizations to which the Government of Canada has made gifts to during the charity's current taxation year or in the 12 months preceding the charity's current taxation year;
- Canadian municipalities, the government of Canada; and
- the government of a Canadian province.

What are advantages of the private foundation?

The private foundation provides flexibility for donors wishing to pursue their philanthropic goals. Of the three types of registered charities (charitable organization, public foundation and private foundation), a private foundation is most suitable for planned giving, mainly because it can be controlled by the donor and the donor's family.

The donor or persons related to the donor are permitted to be a trustees or directors of a private foundation. As a result, they remain in a position to influence or control several aspects of the foundation's operations, including decisions on:

- investment of the donated assets;
- distribution of income earned in the foundation; and
- grants made by the foundation.

The donor's creation of the foundation means that the foundation can be named for the donor or the donor's family. Equally, an entirely unrelated name can be used. As with other registered charities, a private foundation can provide a philanthropic legacy that survives the founder's death.

Many private foundations are founded to coincide with a significant event in the founder's life, such as the sale of a business that generate significant cash proceeds, as is discussed in our "Selling your business" article on page 9, or a windfall.

So, how do you get there?

To be a registered charitable foundation, the entity must apply for and be granted registered charity status by the Canada Revenue Agency (CRA). This involves crafting the constituting documents of the foundation and other governance documents, such as by-laws, and then making an application to the Charities Directorate Division of the CRA on the basis that the foundation's purposes are completely charitable in nature. What is considered charitable in law is generally well established. Essentially, the charity must provide broad public benefit rather than benefiting a few individuals or a closely related group.

Generally, the constituting documents of a charitable foundation are structured to provide broad but exclusively charitable objectives, such as "to financially support organizations that are qualified donees." However, objectives can be stated more

specifically. From the CRA's perspective, a charitable foundation meets the requirements of operating exclusively for charitable purposes if it disburses funds to other qualified donees.

What are the costs and operating requirements?

For a private foundation, initial set-up entails legal and other professional advisory costs, among others. Ongoing costs include accounting (to audit the financial statements and to prepare annual tax filings) and investment management costs for the foundation's investment portfolio. Generally, most charitable foundations are constituted to forbid compensation to the trustees or directors for services in that capacity.

Once a private foundation is established, administrative and governance requirements must be satisfied, such as holding board meetings, maintaining adequate books and records, and issuing donation receipts in accordance with the requirements of the *Income Tax Act (Canada)* and *Income Tax Regulations*. As well, provincial statutes might govern the charity's activities.

Despite the “private” in “private foundation,” much of the information relating to the foundation, its financial position and its activities is subject to public disclosure and scrutiny, because all registered charities are public entities.

How do you fund and operate a private foundation?

Funding generally comes from a single source, such as an individual or family unit or even by businesses related to the founder(s) of the foundation. For a contribution to qualify as a gift for tax receipting purposes, it must be a transfer of property by the donor for which no consideration is expected. Therefore, contributions generally are made without conditions. However, gifts to a private foundation are often structured as enduring property gifts. Enduring property gifts include those gifts for which the donor requests that the capital not be spent for a period 10 years or more from the date the gift was made. These gifts are often referred to as “10-year-plus gifts.” By structuring donations to private foundations as 10-year-plus gifts, the foundation’s capital can accumulate

without being immediately subject to the disbursement requirements that normally apply to charities that receive unrestricted donations.

The operations of a private foundation are managed by directors or trustees that generally do not deal with each other at arm’s length. The trustees and directors may manage the investments themselves and/or delegate the responsibility to an investment management firm, depending on the investment powers that are provided for in the foundation’s constituting documents.

What is the tax treatment of gifts made by a donor to a private foundation?

Cash gifts and gifts of property to a private foundation are eligible to be tax-receipted for the property’s fair value at the time of the gift.¹

A donor can claim a donation tax credit in the case of an individual or a donation tax deduction in the case of a corporation to reduce personal or corporate tax liabilities, subject to annual net income limitations.

Recently enacted tax legislation allows a donor a special donation incentive when publicly traded marketable securities that are listed on a designated stock exchange (referred to as “securities”) are donated to a private foundation. For donations made after March 18, 2007, no portion of the capital gain that arises on the donation of these securities is included in the donor’s income.²

If the donated property is a “non-qualifying security” (such as shares of a private company that the donor owns), there may be restrictions on issuing tax receipts for the donation. Therefore, to ensure that the donor can claim such a gift as a donation for tax purposes, care is required in structuring the donation of private company shares.

What does it mean to be a Canadian registered charity that is designated as a private foundation?

Being a Canadian registered charity means, among other things, that the charity is granted tax-receipting privileges for donations it receives.

1. The amount of the gift that is eligible to be tax-receipted is the fair value of the property donated less the fair value of any advantage or benefit conferred on the donor or persons related to the donor.

2. Certain provincial tax authorities, including Alberta Finance, have not stated whether or not they intend to parallel the proposed federal treatment for gifts of qualifying publicly listed securities to private foundations after March 18, 2007, but that provincial tax authorities are generally expected to provide parallel capital gains tax relief.

A charity's responsibilities and governance continue even after registered status is granted. To maintain registered status, the charity must abide by a number of tax rules. One requirement is to spend a minimum amount each year on its own charitable activities or by way of gifts to qualified donees. The minimum disbursement requirements exist to oblige the charity to use its funds and tax-assisted donations to help others in accordance with its charitable purposes.

In addition, a registered charity that is designated as a private foundation is subject to a number of restrictions, some of which are designed to prevent private benefit. These restrictions include the prohibition from:

- carrying on any business;
- making a gift to a recipient that is not a qualified donee; or
- incurring debt except for certain purposes.

As well, new restrictions can limit a private foundation's shareholdings in corporations, in certain circumstances, and increase reporting of its

shareholdings and that of persons not dealing at arm's length with the private foundation.

Closing considerations

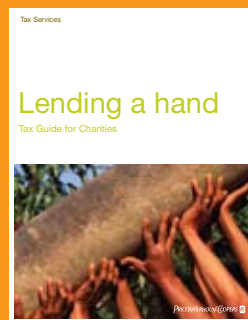
Charitable giving is a win-win opportunity for both donor and charity. Often, creating and shaping charitable giving through one's private foundation is challenging and may give you

considerable flexibility when it comes to fulfilling your philanthropic goals. Planning in advance — and well — can make the philanthropic journey rewarding.

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Two PricewaterhouseCoopers publications deal with charities. *Lending a hand: Tax Guide for Charities* is aimed at the charities themselves, while *Reaching out: Charitable Giving Guide for Donors* is aimed at donors. Both are available in hard copy or on our website at www.pwc.com/ca/taxpublications.



See **How to get copies of future editions of *Wealth and Tax Matters*, on page 33.**

Succession planning part 1

When business becomes a family matter



As an entrepreneur, you have expertise in operating your business successfully. Years of dedication and hard work have built an organization of which you are proud. At some point, however, you likely will want to withdraw from actively running your business, pass it on to capable hands, and enjoy the fruits of your labours.

For a family business, the family issues can make planning for succession difficult and complex. Statistics reveal that even though owners want to pass their business on to family, only three out of ten businesses are owned by second-generation family members and only one out of the ten continues into a third.

A succession plan deals with the owner's eventual withdrawal from daily business activities. It is not a single document, such as a shareholders' agreement, tax plan or will. Rather, it is a combination of these and other documents. Succession has two components:

- management succession, which is the transfer of daily business responsibilities to another person(s): and
- ownership succession, which is the transfer of shares and ultimate voting control over a corporation.

Both take place over several years. Making a succession plan work involves various technical aspects, such as considering tax and legal implications, determining the value of the company and developing financing options.

The primary factor in creating a successful plan is open communication. To enable a smooth transition and better acceptance of new leadership, your succession plan should be communicated to all stakeholders — family members, employees, customers and advisers, demonstrating that the succession plan is well thought out and managed.

The planning process

The best way to begin preparing your succession plan is to determine objectives. These go beyond your business objectives, encompassing the business and non-business objectives of your family and other key stakeholders. One way to open the lines of communication, manage conflict in a constructive manner and help arrive at decisions that are satisfactory to all is to use a capable facilitator in group meetings.

Once objectives are identified, you can begin to work through several succession planning options, such as:

- an intergenerational transfer;
- interim or outside management;

- a sale to key management/ employees; or
- a sale to an outside third party.

Each option should be explored and discussed with all stakeholders before being put in place. Typically, after management succession plans are formalized, ownership succession plans are considered. Several technical aspects of ownership succession must be addressed, such as valuation and tax planning.

Value — What is your business worth?

In many instances, a company's value is what you can negotiate for it in the open market. However, it may not be reasonable to expect a family business to be exposed to this market for succession planning purposes. Notional valuation methods are generally used to establish value. Professional valuers will investigate the market and analyze historic and projected business data, and use judgment to provide an independent valuation.

Because business valuation is part art and part science, it is essential that an experienced valuation practitioner be involved in the process. Often, valuation can have a major effect on succession planning. Distorted values can lead to inappropriate plans and strategies including improper allocation

of value leading to tax-related problems if values are challenged by the tax authorities.

Tax planning

Many people look at succession planning as tax planning. While tax is critical to any estate and succession plan, it is your goals for yourself, your company and future generations that should drive your decisions in creating your succession plan. Assuming that you and your family have set objectives, several tax planning opportunities can be considered for a transfer of ownership. One common method of dealing with the succession of a family business is through an estate freeze.

What is an estate freeze?

An estate freeze involves a reorganization of the business' share capital. Essentially, you would freeze your interest in the business at a particular time by exchanging your shares for fixed value "freeze shares." New "growth shares" would be issued to your family so that they could participate in the future increase in value of the business. Freezing your interest in the business allows you to cap your tax liability at death, so that you may plan for its payment. An estate freeze also may provide other tax advantages such as income splitting with family members and using the

capital gains exemption of other family members if the business is sold.

Family trusts

Typically, on an estate freeze, growth shares are not issued directly to family members but are held by a family trust. This trust can be set up to provide maximum flexibility regarding income and capital distributions. That is, you can decide who should receive distributions and when. This flexibility will allow you to split income by flowing income through to family with little or no other income. However, some complex tax rules can limit your ability to split income with certain family members.

Are you ready to freeze?

You do not have to give up control of the business on an estate freeze. However, before going ahead with one, you should consider a number of issues:

- Do you know the current value of your business?
- Are you satisfied that the value of your business and assets are sufficient to provide for the remainder of your lifetime?
- Do you foresee changes to your financial or family situation?
- Are you ready for family to participate in the equity of the business?

Every tax plan should be unique, because the family and the business are unique. Your options should be fully explored with a qualified tax expert.

Financing the transaction

Many sources of funding are available to assist in succession planning. Depending on the situation, these may include:

- *Vendor Take Back* – a common method of financing in which debt or shares are taken back by the retiring shareholder.
- *Purchaser Equity* – a way for family and/or buyer to provide funds to complete the transaction.
- *Bank Financing* – often, bank financing can be used to bridge succession or finance purchase debt.
- *Merchant Banking* – merchant bankers can help move equity through generations, but the cost can be higher.
- *Insurance* – various insurance products can form part or all of the succession financing.

Potential financiers should be reviewed with professional advisers who can assess the costs and risks.

Financial planning for retirement

When structuring your withdrawal from the business, it is important to consider your future income needs. Determining your requirements can affect the

way you structure the transaction. Working with financial and tax planning specialists can help make decisions that are best for you and your family.

Succession planning – Who can help?

Good succession planning uses a team-based approach – two teams, in fact, one external and one internal. Both teams should be consulted throughout the entire process.

External team	Family business facilitators	Assist in addressing and resolving family, business and ownership issues, maintaining focus and keeping the process moving forward.
	Tax and legal advisers	Provide advice and prepare the appropriate documentation to give effect to your plan.
	Financial and insurance advisers	Help you finance the transaction and determine your future income needs.
	Peers	Offer advice based on similar experiences that they have gone through or are going through.
Internal Team	Advisory committee members	Provide objective opinions.
	Independent board members	
	Family council	Provide input from the family's perspective.

Planning for the unexpected

No matter where you are in the process, for business continuity a contingency plan is critical. When unexpected events occur such as the death or disability of a key stakeholder, a contingency plan informs stakeholders of the steps to be taken, enabling the business to be up and running the very next day, and likely will be the only document that provides

instructions regarding daily operations. The contingency plan should address the specifics of running your business in the short term. On the other hand, your will, shareholders' agreement and other corporate and estate planning documents dictate what will happen to ownership and management in a general sense.

Family business succession planning is a complex process. Stakeholder objectives have to be determined, options must be fully explored

and plans have to be put in place. Succession planning is a process that you should not go through on your own. By using a comprehensive team of advisers and involving all stakeholders in the planning process, you can keep your business in the family from one generation to the next.

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Succession planning part 2

Temperatures may be dropping, but is it time to freeze?

Temperatures are down and so are financial markets around the globe. As investment values decline, it might be a good time to ask yourself “is it time to freeze?”

What is an estate freeze?

An estate freeze is a tax planning technique used to “freeze” the value of a taxpayer’s interest in a company and transfer future growth in the value of the company to someone else — typically the children.

The company can be an operating company or an investment company. An estate freeze may also be possible for assets that are not currently held in a company as long as the taxpayer is willing to transfer the assets to a company, and doing so is prudent.

What are the benefits of an estate freeze?

Typically, the primary reason for an estate freeze is to cap, or “freeze,” the value of a taxpayer’s interest in a company. This provides for a couple of important tax benefits:

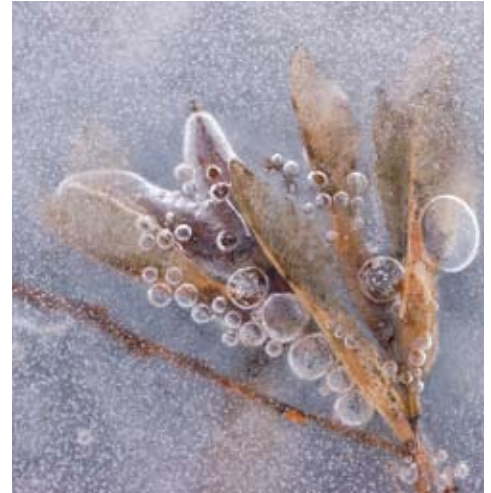
1. The taxpayer’s future tax liability on death is capped. All taxpayers are subject to a deemed disposition of assets on death (except for assets transferred to a spouse or spousal trust, for which the deemed disposition can be deferred until the spouse’s death). Taxes will be payable on any capital gains that result from the deemed disposition. Capping the value of a taxpayer’s interest in a company will also cap

the anticipated tax liability on that interest. In addition, with the amount of tax on death known, effective planning can be carried out to fund the anticipated tax liability.

2. Tax on the future growth is deferred to the next generation. Unrealized capital gains on growth shares owned by children or grandchildren will be deferred until the earlier of their deaths and the time they otherwise dispose of the shares.

Depending on how the estate freeze is structured, additional benefits can include:

- Sharing company dividends among family members who have little or no other income, to split income and reduce total income taxes;
- For an operating company, on properly qualifying shares, the taxpayer can crystallize his or her \$750,000 lifetime capital gains exemption;
- For an operating company, where shares continue to properly qualify after the estate freeze, additional claims for the \$750,000 lifetime capital gains exemption may be available to family members on a future sale of the company; and
- Through proper planning after the estate freeze, the value of the



taxpayer's interest in the company, in addition to being frozen, can be reduced over time without incurring any additional tax using the distribution of company profits. The result could be that the taxpayer's interest in the company generates little or no tax liability on his or her death.

Who should consider an estate freeze?

Anyone who owns growth shares in a company should at least consider an estate freeze. Whether it makes sense depends upon the current value of the interest, the age of the shareholder, the age of his or her children and estate planning objectives. From a tax-planning perspective, because the primary benefit is capping the value of the taxpayer's interest in the company, it is best to freeze when the value of the company is at its lowest.

The typical taxpayer who implements an estate freeze is a person who:

- either through the current value of his or her interest in the company and/or through assets and investments held outside of the company has enough wealth to fund his or her personal lifestyle for his or her lifetime (and perhaps for the lifetime of the spouse); and
- would otherwise be leaving any excess wealth to his or her children after the death of the taxpayer and spouse.

An estate freeze, however, can be structured to benefit many taxpayers

who fall outside this typical picture. In any case, the following planning points should be considered:

- when a discretionary family trust is used to acquire the growth shares, the shares need not be transferred directly into the hands of a child or grandchild for up to 21 years after the date of the estate freeze, providing time for young children or grandchildren to mature enough to manage direct share ownership;
- if the company is an operating company and a discretionary family trust is used to acquire the growth shares, an estate freeze can be implemented without accelerating succession planning decisions; and
- the taxpayer can maintain control over the company by attaching votes to the "freeze" shares, despite transferring the future growth in the company.

Full, partial or flexible freeze?

Effective tax planning does not always require a full freeze of a taxpayer's interest (i.e., one in which the taxpayer maintains no interest in the growth of the company). If preferable in the particular situation, a partial freeze can allow the taxpayer to share in the future growth by acquiring a percentage of the growth shares.

Another option is a flexible freeze where the growth shares are acquired by a discretionary trust that includes the taxpayer as a discretionary beneficiary. The taxpayer's inclusion as a beneficiary permits growth shares to be transferred to him or her if future

circumstances warrant. The flexible freeze is covered in greater detail in "The Flexible Freeze: How to give—without giving it all away."

How can estate freezes go wrong?

Among the pitfalls to be aware of when implementing an estate freeze are:

- corporate attribution rules – which could result in an annual deemed income inclusion to the taxpayer;
- the "kiddie tax" – which results in children under 18 paying tax at the top marginal rate on dividends from private corporations; and
- loss of control – which can occur if the taxpayer does not maintain voting control over the company through voting preferred shares.

To avoid these pitfalls it is essential to seek the advice of a tax professional.

Final thoughts

With financial markets at their lowest levels in years and a slowing economy, values of investment portfolios and operating businesses have dropped significantly. That means that there is no time like the present to consider an estate freeze to lock in the reduced fair market values for tax planning purposes and to share the future growth with family members.

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Succession planning part 3

The flexible freeze: How to give—without giving it all away

What is a “flexible freeze”? What are the benefits of this type of estate freeze compared to a “traditional” freeze? When should an owner-manager consider implementing a flexible freeze? These are some of the questions that we wish to address in this article. Although the flexible freeze is not new, it remains highly relevant because it can offer a whole range of financial and tax benefits.

An example

David, 48, is the sole shareholder of a corporation that operates a high-growth business established a number of years ago — conveniently named “David Co.” The corporation is currently valued at approximately \$4 million, but that amount could increase significantly over the coming years. David and his spouse, Audrey, have two children: Paul, aged 14 and Nancy, who is 12. David, his family and David Co. are all residents of Canada.

David is wondering whether he should implement an estate freeze using a discretionary trust for the sole benefit of his children.

Not an ideal candidate for a “traditional” freeze?

By definition, a “traditional freeze” involves a permanent transfer of the future increase in value of the corporation to the beneficiaries of the freeze — usually the children of the taxpayer. The permanent nature of the transfer makes David doubt whether a freeze would be appropriate. He knows that the \$4 million in accumulated value does not guarantee that he will be able to maintain his lifestyle when he retires. As well, given the young age of his children, the various ways in which his family situation could evolve (maturity levels of the children, marriage or financial situation, involvement in the organization, etc.) could someday lead to regret about a permanent transfer of value.



If you are not familiar with the concepts of a freeze and of a discretionary trust, we recommend that you read the previous article in this edition, “Temperatures may be dropping, but is it time to freeze?” by Angela Ross and Nicholas Karkas, and the articles on trust basics published in the autumn 2008 issue of *Wealth and Tax Matters*.

What is a flexible freeze?

A flexible freeze structure is designed to avoid the inherent pitfalls of traditional freezes. If the accumulated capital at the date of the freeze turns out to be insufficient, a flexible freeze enables the parent to benefit from the corporation's future increase in value. Similarly, in the event of a change in circumstances, the parent can fully reverse the freeze and recover all the assets in the trust.

In David's case, this result is reached simply by including himself as one of the beneficiaries of the discretionary trust. Just like the other beneficiaries – and in accordance with his needs and circumstances – David will be able to benefit from the dividends received by the trust on the common shares of David Co., or from a total or partial distribution of the trust's assets (including any shares of David Co.). Of course, if it turns out that David does not need or want to receive distributions from the trust, the initial planned transfer of value to his children can be carried out in full.

How does David benefit?

Because a flexible freeze can be reversed in whole or in part, the main advantage is that an estate can be frozen prudently much earlier than under the traditional approach. This in turn leads to other advantages. Fixing the value of David's equity interest at a relatively low amount could facilitate the eventual transfer of ownership of the corporation under a business succession plan, on account of the reduced purchase price required. In addition, a freeze now could limit the deemed proceeds for tax purposes on the disposition of his equity interest in David Co. at his death to a maximum of \$4 million. That in itself could create a significant tax deferral.

Furthermore, should the corporation be sold, the accumulated value of the shares held in trust will usually be higher for an early freeze. With the flexibility offered by a discretionary trust, the trustees will be able to allocate the gain realized by the trust among the beneficiaries and maximize the use of the \$750,000 capital gains exemption available for each family

member. Finally, when the children reach the age of majority, dividend payments could be distributed to split income among family members with little or no income.

When should a flexible freeze be implemented?

As mentioned above, it is generally best to implement a flexible freeze as early as possible. In practice, however, the children's age is often a deciding factor in delaying the implementation of this type of planning.

In fact, for tax purposes, the trust used in a freeze is deemed to dispose of all its property at fair market value on its twenty-first anniversary. More often than not, to avoid a deemed disposition, the trust will distribute property (a tax-deferred transaction) to the beneficiaries before the twenty-first anniversary. Making this distribution when the children are relatively young, say 22 or 23 years old, can be a problem because it could involve the distribution of property with substantial value to children who may not yet be mature enough.

For this reason, many flexible freezes are implemented when children are ten years old or more. However, this is by no means a firm rule.

Other considerations

The items summarized below should be considered when implementing a flexible freeze. Some also apply to other types of freezes.

- **Involvement of third parties and control:** The parent is usually one of the trustees of the trust used in the freeze, but has to share the task with other trustees. When implementing a flexible freeze, there are limitations to the level of control that may be granted to the parent.
- **Spouse as a beneficiary:** As is the case with a traditional freeze, a spouse as a beneficiary of the trust in a flexible freeze can be inappropriate, particularly because of the application of certain attribution rules. Whether

or not to include a spouse must therefore be determined by carefully weighing all the tax implications and the anticipated benefits.

- **Active successors in the family:** A flexible freeze structure is rarely recommended when successors are already active in the corporate operations. A structure that involves a potential return of the increase in value to the parent can be demotivating for active successors, who naturally want to be rewarded for their efforts.
- **Careful implementation of the structure:** Although the flexible freeze is a well understood structure, careful attention to its implementation is crucial. In fact, our tax laws include several traps. Among other things, an erroneous valuation of the corporation, an inappropriate choice of trustees or beneficiaries and/or poor drafting of the trust deed can create major tax problems.

In short, a flexible freeze is a shareholding structure that is highly flexible from a financial point of view and that may include significant tax benefits, depending on the circumstances. It can apply to many situations and is worth considering by business owners as part of a periodic review of their financial and tax positions.

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Taxable vs. non-taxable benefits

Understanding the basics



The variety of benefits provided to employees and corporate officers can make it difficult to distinguish those that are taxable in the hands of the recipient from those that are not. The issue becomes cloudier still when that employee or officer is a significant shareholder of the corporation.

In general, the income tax legislation governing employee benefits requires an individual to include the value of any benefit received or enjoyed by virtue of his or her office or employment in employment income. Jurisprudence, however, has established that if an outlay or expense is incurred primarily for the benefit of the employer, no amount will be taxable to the employee or officer, despite the fact that the individual may have enjoyed some incidental benefit. Furthermore, various administrative and legislative concessions offer tax relief for specific employee benefits.

When an employee or officer is also a significant shareholder of the corporation, it is important to determine whether he or she has received the benefit in the capacity of a shareholder or employee, because:

- taxable employee benefits qualify as earned income for various income tax purposes (e.g., RRSP contribution limits); but
- taxable shareholder benefits are included as non-employment income or as deemed dividends, neither of which constitute earned income.

Although a “benefit” is not defined for income tax purposes, the courts have traditionally applied a broad interpretation of the term to mean any economic advantage received by the individual, whether cash or non-cash. As well, if a taxable benefit is considered to have been conferred on another person by a corporation at the direction of a shareholder of that corporation, the shareholder, rather than the actual recipient, will be taxed on the value of the benefit.

The purpose of this article is more modest than to provide a broad, thorough analysis of all forms of taxable and non-taxable benefits. Instead, it will highlight some commonly overlooked items. Comprehensive material on the taxation of employee and shareholder benefits can be found in various Canada Revenue Agency publications (e.g., *T4130 Employers' Guide – Taxable Benefits* or *IT432-R2 Benefits Conferred on Shareholders*) or in the various publications on our website at www.pwc.com/ca/taxpublications.

Taxable employee benefits

- **Low-interest or interest-free loans:** Apart from certain loans, if an employee receives a low-interest or interest-free loan from a corporation, a taxable benefit will arise. The taxable benefit is equal to the difference between the prescribed interest rate(s) in effect for the period and the amount of interest actually paid in the year or within 30 days after the end of the year. Depending on the use of the borrowed funds, the employee may be entitled to claim a corresponding deduction for interest expense deemed paid.
- **Recreational facility and club dues:** When an employer pays, reimburses or subsidizes the cost of an employee's membership at a recreational facility or professional club, the employee is deemed to have received a taxable benefit, unless the membership is maintained principally for the employer's advantage. If the employer provides recreational facilities, whether in-house or not, to all employees at the same cost and it can be shown that the employee's membership in these facilities is maintained primarily for the employer's advantage, no taxable benefit to the employee should arise.
- **Spouse or common-law partner's travel expenses:** Travel expenses paid or reimbursed by an employer for an employee's spouse or common-law partner will typically result in a taxable benefit to that employee unless the employer specifically requested that the spouse or common-law partner accompany the employee on the trip and the spouse or common-law partner was primarily engaged in the employer's business activities during the trip.
- **Frequent-flyer points:** Frequent-flyer points accumulated by an employee on employer-paid travel and used by the employee for personal use is a taxable benefit. An employer that does not control the points accumulated in the frequent-flyer program is not responsible for reporting the benefit, but the employee is responsible for self-assessing the benefit.

- **Parking and automobile benefits**

– Parking provided by an employer, regardless of whether or not the parking lot is owned by the employer, will generally result in a taxable benefit to the employee equal to the fair market value of the parking provided, less any amount paid by the employee for the use of the space. However, no taxable benefit will arise if free parking is made available to both employees and non-employees, when only “scramble” parking is made available (i.e., there are fewer spaces than employees who need parking such that availability is based on a first-come, first-served basis), or where parking is provided for business purposes and employees must regularly use an automobile to perform their duties.

For details on automobile benefits, see the PricewaterhouseCoopers publication *Car Expenses and Benefits – A Tax Guide (2009)* at www.pwc.com/ca/carexpenses.

Non-taxable employee benefits

- **Child care expenses** – Employer-provided child care services are not considered a taxable benefit if they are managed directly by the employer and provided:

- at the employer’s place of business;
- to all employees at little or no cost; and
- exclusively to employees and not to the general public.

- **Social event involving all employees** – Employee social events can be provided as a non-taxable benefit if the cost of each event does not exceed \$100 per employee and the event includes all employees. The employer can fully deduct the expenses for food, meals and entertainment for six or fewer such events for their employees during the year.

- **Cells phone plans and Internet service** – Cell phone and at-home Internet service plans paid for by the employer are generally non-taxable benefits if the plans are reasonable and are used primarily for business purposes. Any incidental personal use of the services that does not

contribute to additional charges under the plan would not be regarded as a taxable benefit. However, any personal use portion that results in additional charges under the plan, or the inclusion of features beyond the reasonable business needs of the employee, will result in a taxable benefit.

- **Gifts and awards** – Employees may receive up to two non-cash gifts each year on a tax-free basis, for special occasions such as a religious holiday, a birthday, a wedding, or the birth of a child, if the total cost of these gifts does not exceed \$500 per year, including taxes. The same limits apply to non-cash awards given to employees for employment-related accomplishments, such as long or outstanding service, but not for awards given in respect of the achievement of an economic objective, such as meeting sales targets. Gifts and awards will be considered a taxable benefit to the employee if they are:

- in cash or near-cash (e.g., gift certificates); or
- purchased by the employee, who is reimbursed by the employer.

Shareholder benefits

In contrast to benefits provided to employees, benefits conferred upon shareholders are generally subject to more stringent legislation, which is intended to prevent tax-free distributions to shareholders.

In general, any appropriation of property or conferral of economic benefit (other than those made for bona fide business purposes) could potentially be considered a taxable shareholder benefit.

In contrast to the potential non-taxable nature of gifts and awards provided to employees (as discussed above), any gifts and awards given to shareholders or related persons from closely held corporations will be fully taxable.

Furthermore, if a low-interest or interest-free loan is extended by a corporation to a shareholder who owns more than 10% of the issued shares of that corporation, the shareholder will be considered to have received a benefit. This benefit will be valued in the same way as described above for

a low-interest or interest-free loan to an employee (prescribed interest less interest paid in the year or within 30 days after year end). However, if the loan remains outstanding one year after the end of the year in which the loan was made, the full amount of the loan is included into income as a shareholder benefit.

Additional considerations

The distinction between taxable and non-taxable benefits is important, not only for calculating the recipient's income inclusion for the year, but also for determining the necessary reporting and withholding tax requirements. An employer is required to report the value of a taxable benefit, or a reasonable estimate, in the employee's T4 Supplementary for the year. In addition, taxable employee benefits are generally subject to CPP and EI withholdings, and may have GST/HST implications.

As this article demonstrates, while benefits can offer unique opportunities for an employer to reward and compensate its employees and officers, to prevent unintended income tax consequences to both the employer and employee, the nature of the benefit and the context under which it is provided needs careful consideration.

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