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TAX ALERT

Individual PENSION PLANS

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An individuals' income at retirement typically includes income from investments, government pensions, inheritances and, most commonly, RRSPs. In certain cases, however, an Individual Pension Plan (IPP) can be a useful alternative to the more widely accepted RRSPs.

An IPP is a single-member registered defined benefit pension plan that allows the member the opportunity to accrue pension income on a tax-deferred basis. IPPs are designed to maximize contributions under the Income Tax Act and under the right conditions.

IPPs are structured similarly to larger entity defined pension plans. Each IPP is sponsored by an active corporation, its member is an employee having T4 income, and it must specify the structure of the benefit to be paid to the plan member. Investments held within the plan are restricted. Benefits paid out of the IPP are taxed upon receipt.

The amount of each contribution depends on the member's age and salary, and is subject to certain legislative restrictions.

Restrictions on the investments held within an IPP include:

- investments should not be made in the securities of the pension plan sponsor;
- margin accounts are not permitted; and
- individual securities may not exceed 10% of the book value of the fund at the time the security is acquired.

IPP contributions must be calculated by an actuary based on defined actuarial formulas.

The amount of each contribution depends on the member's age and salary, and is subject to certain legislative restrictions. Typically, if the member is over the age of 40, the annual contribution will normally exceed the maximum RRSP limit. When an IPP is established, a one-time past service adjustment is included in the calculation. This adjustment can be significant in some cases.

Good candidates for IPPs include incorporated business owners, incorporated professionals, and senior executives in the age range of 40-71 years who have consistently drawn an annual salary of $100,000 or more over several years. Typically, these individuals have past service with the corporation dating back to 1991.

The reasons to establish an IPP can include the following:

- to diversify a retirement strategy;
- to significantly increase retirement savings over a relatively short time frame;
- to deduct the contributions in a corporation; and
- to have a plan that is creditor-proof.

An IPP may also provide a tax-efficient method of transferring value in succession planning or on the sale of a business.

The primary differences and similarities between IPPs and RRSPs are summarized in this chart.

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Issue	IPP	RRSP
Advantages of an IPP		
Poor performance of plan relative to actuarial assumptions	Permitted to fund deficiency and receive a tax deduction	Not permitted to fund deficiencies
Investment management fees	Deductible by the corporation	No tax deduction
Pension income splitting with spouse	Eligible	Eligible
Pension credit	Eligible	Eligible
Deductibility of interest on funds used to make the contribution	Deductible	Not deductible
Disadvantages of an IPP		
Availability of funds	Locked in until retirement	Funds are accessible at any time
Mandatory funding	Funding must be made regardless of the company's profitability	At the plan-holder's discretion and up to the permitted restrictions
Use of spouse	No spousal IPP, however, offset by pension income splitting	Use of spousal RRSP and pension income splitting.
Good performance of plan relative to actuarial assumptions	Will restrict future contributions and tax deduction	Still able to make regular contributions based on RRSP plan restrictions
Administration costs	Higher than RRSP	Some costs

The list is not meant to be exhaustive.

IPPs are complex, but can be used effectively in any estate plan.

Contact your Collins Barrow advisor to discuss the advantages and disadvantages of an IPP in the context of your financial circumstances. §

Planning with
DISCRETIONARY FAMILY TRUSTS

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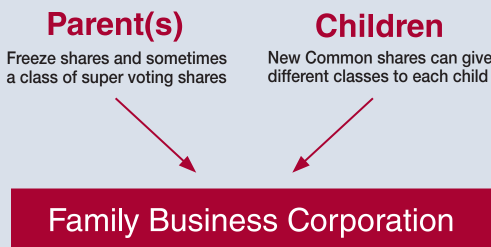
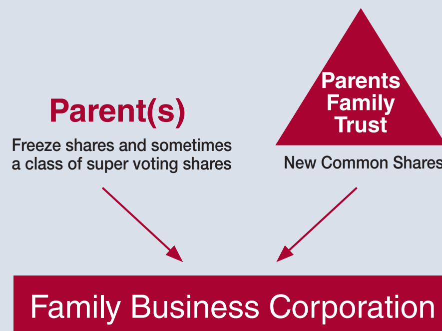
When owners of family business corporations seek to transition their businesses to their children, they often do so through what are known as estate freezes. In such transactions, the parents exchange their common shares for fixed value shares, typically preference shares, with a redemption amount equal to the value of the business (including goodwill). New common shares, to which future value increases accrue, are issued to the heir(s) apparent. The parents must determine how many common shares – and therefore the portion of the future growth of the business – are to be received by each of their adult children. This structure can be illustrated as follows:



Though there are benefits to estate freezes, such a structure may not provide the family with sufficient flexibility to address changing circumstances.

A common alternative is the discretionary family trust. With discretionary family trusts, the parents still exchange their common shares for fixed value freeze shares, but the new common shares are issued to a family trust rather than to the children. The beneficiaries of the trust often include the parents, the children (and their spouses), and any grandchildren. The trust is governed by trustees who generally include the parents and an arm's-length party.

This structure can be illustrated as follows:



Discretionary family trusts are an exceptionally flexible vehicle providing the following benefits:

- Future business-asset wealth can be transferred to the next generation while maintaining voting and operational control of the business. At Collins Barrow, we generally recommend that individuals undertaking estate freezes in favor of their families retain voting control of the company at least until they have received the value of their freeze shares.
- Properly structured arrangements can be reversed (known as an "estate freeze thaw") where parental circumstances (financial requirements, death or disability of one or more heir(s) apparent) or beliefs change.
- The trust can provide protection from beneficiaries who may attempt to exert claims or entitlements to the income or assets of the trust. Trustees have sole discretion as to how trust income and capital is allocated among the beneficiaries. In some circumstances, protection of family assets in the event of a marital breakdown of children-beneficiaries can be achieved (though legal advice is recommended in such cases).

- Taxes (on any post-freeze value growth) otherwise due on the death of the parent(s) can be deferred to the later date of an arm's-length sale or the death of the next generation. In Ontario, for example, at current personal tax rates, approximately $230,000 can be deferred for every $1 million increase in value.
- The trust can provide for multiplying the capital gains exemptions by allowing multiple individual family members to realize the exemption in respect of capital gains on the sale of shares of qualified small business corporations (QSBCs), certain farming or fishing assets, farming or fishing partnerships, and farming or fishing corporations. Although trusts may not claim the capital gains exemption, trustees can allocate and distribute such gains to beneficiaries. The recipient beneficiary, not the trust, is taxed as if that particular beneficiary had realized the capital gain directly. (This is also the case with dividends from Canadian corporations where the trust allocates and pays such amounts to beneficiaries.) Individuals generally can claim a capital gains exemption in respect of gains realized from the sale of QSBC shares (and certain farming/fishing assets, partnerships and corporations). In general terms, a QSBC is a corporation in which more than 90% of the fair market value of all its operating assets (Active Assets) and those of its subsidiaries are used primarily in Canada, principally in carrying on an active business. Redundant assets such as portfolio investments, cash surrender value of life insurance policies, excessive cash deposits, shareholder loans receivable and certain intercompany loans are not considered Active Assets. There is a further requirement that at all times in the two years before a disposition, more than 50% of the QSBC's total assets must be used in carrying on an active business in Canada. If these and other criteria are satisfied, the individual beneficiaries, subject to their personal tax circumstances, would be eligible to claim a capital gains exemption.
- Discretionary family trusts allow for income splitting with lower-income individual family members over the age of 17. In most family planning circumstances, the amounts allocated and paid to beneficiaries by the trust would be dividends from Canadian corporations. Where an individual beneficiary has no other income, over $30,000 of such dividends can be allocated to that beneficiary without incurring any significant personal income tax liability. This can be an effective tax planning strategy in funding children's education.

There are three caveats to keep in mind when using discretionary family trusts:

1. Where an estate freeze is implemented and minor children or the spouse of the persons executing the freeze are beneficiaries of a trust, corporate attribution can apply. This concept was discussed in the spring 2009 edition of Tax Alert. Where these provisions apply, the parent(s) would be deemed to receive a dividend each year equal to a percentage (as set four times per year by the Canada Revenue Agency) of the fair market value of the shares received in the course of the freeze and to the extent they remain outstanding. The good news is that these punitive rules do not apply if the corporation subject to the estate freeze is at all material times a QSBC. Therefore, when trusts are used in family business planning scenarios, a mechanism should be incorporated to maintain the freeze corporation as a QSBC.
2. The trust will exist until all the assets are distributed to the beneficiaries and the trust is wound up. A discretionary family trust is deemed to dispose of its capital assets every 21 years on the anniversary of the trust creation, at the fair market value of

such assets at that time. This rule is intended to prevent an indefinite deferral of the recognition of accrued gains on capital and other specified types of property. Therefore, if the trust holds common shares of privately held companies, inherent gains would be triggered every 21 years. The good news is that the 21-year deemed disposition rule can be avoided as the Act generally allows the trustees to make a tax-deferred distribution of trust capital property to Canadian resident beneficiaries in satisfaction of all or part of their capital interest in the trust. The result, absent an arm's-length sale, is to defer the tax on gains in respect of assets held in the trust to the date that is the earliest of the death of the recipient beneficiary, or an arm's-length sale. Although this deemed disposition rule, in essence, places a 21-year limit on the timeframe for the benefits noted above, the period generally is more than sufficient to execute the objectives and obtain the primary benefits of any income splitting and estate/succession planning in respect of Canadian private corporations and their shareholders.

Even at the end of 21 years, and though assets may be distributed to the beneficiaries, it may be possible for the trustees to retain effective control of the trust assets as well as any future growth in value of the trust's assets beyond the 21-year anniversary date.

3. There are a number of specific technical and administrative requirements and anti-avoidance provisions that must be satisfied to establish and operate a family trust successfully. Some of these issues will be discussed in future editions of *Tax Alert*.

Contact your Collins Barrow advisor for more information on the use of trusts in family and business planning. **§**

Uncle Sam MAY WANT (TO TAX) YOU!

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During the last few years, Uncle Sam has been talking to his cousins in Ottawa. These discussions resulted in amendments to the Canada-U.S. Tax Treaty (the Treaty) and new initiatives to share tax filing information on both sides of the border. If you travel or do business in the United States, or plan to do so, there are a number of U.S. tax issues about which you should be aware.

U.S. Corporate Income Taxes

If your company does business in the United States, you will be exempt from U.S. federal income tax under the Treaty if there is no "permanent establishment" in the U.S. But Uncle Sam will require you to file a tax return to claim your Treaty exemption if your trade or business is "effectively connected with the conduct of a trade or business in the U.S."

Although there are rules in the Treaty to help determine if you have a "permanent establishment," there is limited statutory guidance for determining if your trade or business is "effectively connected with the conduct of a trade or business in the U.S." The determination will be based on the facts and circumstances of your situation. Generally, it takes only minimal U.S. activity to meet this threshold.

If you have, or intend to have, a "permanent establishment" in the United States, proper tax planning will be needed to minimize the overall tax burden arising from Canadian and U.S. income tax on the business activities in the U.S.

Each U.S. state has its own rules concerning corporate income tax. These rules vary significantly and most states do not follow the Treaty. There are even some U.S. cities and localities that impose their

own corporate income taxes.

Payroll Taxes

Uncle Sam is interested in more than just corporate income taxes. If an employee of your Canadian corporation takes a business trip to the United States, the U.S. workdays will, in most cases, create a U.S. federal reporting requirement even if the employee would be exempt from U.S. federal tax under the Treaty. There might even be a state reporting requirement. In addition, your company may be obligated to report the U.S. source compensation for the U.S. workdays on a wage reporting slip, and may have to deal with U.S. withholding obligations.

Sales Taxes and Use Taxes

While there are no federal sales taxes or use taxes, each state has some type of sales tax or use tax regime, and the rules vary significantly from state to state. In some states, it takes only a minimal amount of activity to trigger filing obligations. If your company is selling or plans to sell in a U.S. state, you should be aware of the rules applicable in that state. As with corporate income taxes, some U.S. cities also impose their own sales taxes.

Personal Income Taxes

If you are a non-resident of the United States, Uncle Sam will seek to tax you only on your U.S. source income. If you are deemed to be a resident of the U.S., or if you are a U.S. citizen, you will be taxed on your worldwide income. Two tests, the *Green Card Test and the Substantial Presence Test*, will apply to determine whether you are a U.S. resident.

Green Card Test

If you hold a U.S. Green Card, you are deemed to be a resident of the U.S. and will be required to file a U.S. tax return. Since you would also be a resident of Canada for Canadian tax purposes, the Treaty provides tie-breaker rules to determine where you will pay taxes. If, under these rules, you are deemed to be a resident of Canada and a non-resident of the U.S., Uncle Sam will still require you to file a U.S. tax return.

Substantial Presence Test

The Substantial Presence Test is based on days of presence in the United States during the current and previous two calendar years. It is a rolling average test. For example, to calculate the number of days for 2010, add all the days of presence in the U.S. in 2010 plus 1/3 of the days in 2009 plus 1/6 of the days in 2008. If the calculation results in 183 days or more, you would meet the *Substantial Presence Test* for 2010. If you spend less than 183 days or more in the U.S. in 2010, you will only have to file a two-page Closer Connection Form. If you spend more than 183 days or more in the U.S. in 2010, a U.S. tax return is required. Again, since you would also be a resident of Canada for Canadian income tax purposes, the tie-breaker rules in the Treaty will apply. If you are deemed to be a resident of Canada and a non-resident of the U.S., Uncle Sam will want you to file a tax return to claim Treaty protection.

As with corporate taxes, each U.S. state has different rules for personal income tax. Those rules can vary significantly, and most states do not follow the Treaty. If you spend time working in a U.S. state, you should review the applicable rules for that state. Some U.S. cities impose their own personal income taxes as well.

As in Canada, penalties can apply for failure to file the appropriate U.S. tax documentation. But with all these different taxes and different rules, it can be difficult to know your obligations. Contact your Collins Barrow advisor to discuss what, if any, U.S. tax compliance obligations you have and what tax planning is required. Collins Barrow also has access to a full range of U.S.-based tax resources through our affiliation with Baker Tilley International. §

Recent Trends in

U.S. Tax Legislation

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On December 17, 2010, President Obama signed into law the $858 billion *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (the 2010 Tax Relief Act) extending the existing reduced tax rates in the U.S. that would otherwise have expired on January 1, 2011. The Act extends the Bush-era individual and capital gains/ dividend tax cuts for all taxpayers for two years, extends certain business incentives, and provides a compromise in the U.S. estate tax rules. This article discusses some highlights of the 2010 Tax Relief Act, and their effect on U.S. taxpayers.

Individuals

Tax Rates: Capital Gains and Dividends

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the individual income tax rates had been scheduled to revert from their current levels, which have a top personal tax rate of 35% to 39.6%, after December 31, 2010. The 2010 Tax Relief Act extends all individual rates at 10, 15, 25, 28, 33 and 35% for two years, through December 31, 2012.

Qualified capital gains and dividends are taxed at a maximum rate of 15% (0% for taxpayers in the 10% and 15% income tax brackets) for 2010. The 2010 Tax Relief Act continues this treatment for two years, through December 31, 2012.

Qualified dividends, which remain eligible for the reduced tax rates, are dividends received from a domestic corporation or a qualified foreign corporation, on which the underlying stock is held for at least 61 days within a specified 121-day period. A qualified foreign corporation is one that is eligible for U.S. treaty benefits or has stock that is readily tradable on an established U.S. securities market. The reduced tax rates do not apply to dividends received from an organization that is exempt from U.S. taxation.

Estate Tax

The estate tax will be reinstated in 2011 and 2012 with a 35% top rate and a $5 million individual exemption modified for inflation after 2011. For the estates of decedents dying in 2010, the law allows executors to elect either the new levels or the prior 2010 regime with no estate tax and modified carryover basis rules. If the U.S. Congress had not acted, the estate tax would have returned in 2011 with a 55% top rate and only a $1 million individual exemption.

The 2010 Tax Relief Act provides for "portability" between spouses of the estate tax applicable exclusion amount. Generally, portability would allow a surviving spouse to elect to take advantage of the unused portion of the estate tax applicable exclusion amount of his or her predeceased spouse, thereby providing the surviving spouse with a larger exclusion amount. A "deceased spousal unused exclusion amount" would be available to the surviving spouse only if an election is made on a timely filed estate tax return. Portability would be available to the estates of decedents dying after December 31, 2010. With the election and careful estate planning, married couples can effectively shield up to $10 million from estate tax by maximizing each spouse's $5 million applicable exclusion. Because this provision is scheduled to "sunset" after 2012, the utility of the portability election is limited to situations in which both spouses die within the two-year period (that is, 2011-2012).

The Act also expands the lifetime gift exemption to $5 million ($10 million for couples), up from the current level of $1 million ($2 million for couples), and imposes a 35% gift tax on amounts over that threshold through 2012.

Business Incentives

100% Bonus Depreciation

The 2010 Tax Relief Act boosts bonus depreciation from 50% to 100% for qualified investments made after September 8, 2010 and before January 1, 2012. The Act also makes 50% bonus depreciation available for qualified property placed in service after December 31, 2011 and before January 1, 2013. Certain long-lived property and transportation property is eligible for 100% expensing if placed in service before January 1, 2013

Section 179 Expensing

The U.S. Congress has repeatedly increased the dollar and investment limits under Code section 179 to encourage business spending. The 2010 Small Business Jobs Act increased the section 179 dollar and investment limits to $500,000 and $2 million, respectively, for tax years beginning in 2010 and 2011. The 2010 Tax Relief Act provides for a $125,000 dollar limit and a $500,000 investment limit (both limits indexed for inflation) for tax years beginning in 2012 (and sunsetting after December 31, 2012). The Act also extends the treatment of off-the-shelf computer software as qualifying property if placed in service before 2013.

Research Tax Credit

The section 41 research tax credit expired at the end of 2009. The 2010 Tax Relief Act renews the credit for two years, through December 31, 2011, and is effective for amounts paid or incurred after December 31, 2009.

Small Business Stock

The 2010 Small Business Jobs Act enhanced the exclusion of gains from qualified small business stock to non-corporate taxpayers. For stock acquired after September 27, 2010 and before January 1, 2011, and held for at least five years, the 2010 Small Business Jobs Act provided an exclusion of 100% of the gain. The 2010 Tax Relief Act extends the 100% exclusion for one more year, for stock acquired before January 1, 2012.

Contact your Collins Barrow advisor for further information regarding US Tax. **§**

Collins Barrow publishes a quarterly Tax Alert for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Alert suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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