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Achieving philanthropic goals for your clients

Advice for Advisors

APRIL 2011

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Tax strategies for the HNW family

by **Pearl E. Schusheim & Steve Landau**

No two family scenarios are the same, and this is especially true when it comes to clients with significant sources of wealth.

Their wealth may come from operating or selling a successful business, an inheritance, a wise investment or other sources. They may have children or others who depend on them for support, at different ages and stages of life. Their personal and family values, and objectives regarding wealth succession, will also vary. Some will have done no previous planning, while others will already have implemented some planning that may involve wills, holding companies and trusts.

What is common among these high-net-worth clients, however, is they'll face a variety of wealth-related issues on which they'll want or need advice, with particular focus on how to reduce and save tax.

In particular, tax minimization is often an important objective for high-net-worth clients. You'll want to advise them on how they can minimize their overall family tax burden, both during their lifetime and on death, using various income-splitting strategies, trusts, insurance strategies and will-planning techniques. Here's how.

Income splitting

Despite extensive attribution rules designed to prevent the splitting of family income with lower-taxed family members, there are still some opportunities to do so.

A prescribed rate loan, for example, can be made to a lower-taxed family member, or to a trust for the benefit of several family members, with the income on the invested proceeds being taxed at the lower tax rate applicable to the borrower. Provided the loan requires interest to be paid, and is paid to the lender at the prescribed rate set by the government (currently 1%), there's no attribution of that income back to the lender.

These types of loans can be made to a spouse or minor child directly or through an inter vivos trust. The advantage to using a trust where several family members are beneficiaries is there can be flexibility as to the distribution of income. This can also be an effective way to fund education costs. The income from the loan proceeds can fund their tuition, books, other school activity costs and certain other personal expenses.

And the loan can always be repaid to the lender and the income-splitting arrangement reversed if the tax results are no longer advantageous.

Alternatively, an outright gift can be made to a trust where the income and gains generated can be distributed to various family members. The ability to distribute income to a spouse and minors will be limited, but it'll be possible to funnel income to other relatives.

Often, wealthy individuals assume responsibility for helping other family members in need, whether parents, grandparents or others. Typically, an outright gift will be made to the recipient, and this will be funded by after-tax dollars.

A more tax-effective way to fund such a gift is to make an income distribution to that relative as a beneficiary of a trust, the income from which can be paid to the relative-beneficiary, deducted from the income of the trust and taxed at the lower tax rate that applies to the individual.

Where there are disabled children for whom a disability tax credit is claimed, a preferred beneficiary designation can be made. That designation allows income to be allocated and taxed to the preferred beneficiary without having to make an actual distribution to that person.

Salaries and shares

In the right circumstances, such as where your client owns and operates a business, it may be possible to employ family members and pay them salaries for services rendered to the business. The salary paid, however, must be reasonable for the services actually provided.

Where the business is operated through a corporation that meets the income tax definition of "small business corporation," it's also possible to pay dividends on shares held by, or for the benefit of, low-tax-rate family members. In that case, the shareholders don't have to render services to the corporation, and they can receive dividends in the capacity of shareholder. Remember, though: A small business corporation is a Canadian-controlled private corporation that uses more than 90% of the FMV of its assets in an active business carried on primarily in Canada. So operating companies with foreign operations or significant investment assets may not qualify.

Different classes of shares can be issued to different family members and the dividend rights can be discretionary. This will allow for the payment of dividends on some classes of shares and not on others, enabling the streaming of dividends to those shareholders who need the funds and who will pay tax on the dividends at a lower rate. But it's critical that the company is a small business corporation and the shareholders purchase their shares with their own funds or funds borrowed from an arm's-length lender.

There's greater flexibility to make distributions of dividends from an investment corporation or income from a trust to children who are 18 years of age or older. This will be a good way to finance post-secondary education costs on a tax-efficient basis.

Tax Strategies for the HNW Family *(cont'd)*

When an investment company pays dividends to its shareholders, it'll receive a refund of part of the tax it paid on the investment income. And when the dividends are received by shareholders with little or no other income, they may not pay any tax on the receipt of the dividends. This substantially reduces the effective tax rate on the investment income earned by the company. Other sources of business income can be earned by a trust and flowed through the trust to be distributed among multiple low-rate taxpayers. For example, a trust can provide management or other types of services through its employees, retaining significant profits that can be allocated to the beneficiaries.

But these arrangements are complex, and the broad anti-avoidance rules must be carefully considered.

Use of trusts

The high-net-worth client will be as interested in deferring tax as in saving tax—and trusts are often a useful means of doing so.

Normally, the transfer or disposition of property will occur at fair market value, which triggers the realization of accrued gains in the property. However, this tax realization event will be deferred where property is transferred between spouses or common-law partners, or to special types of trusts for the benefit of a spouse or common-law partner. Any tax on accrued gains will only be payable when the property is actually sold, or upon the death of the surviving spouse or partner.

Note, though, that while the use of a spouse or partner trust can achieve a significant deferral of tax, it may also allow the high-net-worth client to retain some measure of control and decision-making over the property in the trust, provided the broad attribution rules don't apply. The trust can provide a scheme of distribution (whether fixed or flexible) that can remain in place long after the trust is established.

Generally, there's a tax-realization event or deemed disposition on any accrued gains or losses in the trust every 21 years following its formation. This 21-year rule must be kept in mind in any tax-planning structures involving trusts.

Will planning and death

The high-net-worth client will need your advice on how to distribute the family wealth after his or her death. So, the entire asset picture should be examined on a regular basis in light of changing personal circumstances and to ensure the tax burden on death is minimized.

It's essential that your client have a will that's fairly current—and possibly, more than one will to deal with different assets and jurisdictions.

Where provincial probate tax is applicable and may be significant, probate tax reduction strategies should be considered. This may involve transferring assets, such as the family cottage or non-appreciated assets, to a family or alter ego trust, with the effect that the transferred asset won't be owned by an individual on death.

It may also be effective to use multiple trusts to address different types of assets, thereby shielding certain assets from the probate tax net.

A trust established under a will is a testamentary trust and it will be taxed in a more favourable way than an inter vivos trust. An inter vivos trust is taxed at the top marginal tax rate on every dollar of income, while a testamentary trust enjoys the graduated rates of tax.

Multiplying access to the graduated rates achieves absolute tax savings. For this reason, some of the income of an estate can be retained and taxed in the estate (or testamentary trust) until the top marginal rate is reached, and then the balance can be allocated to the beneficiaries. In fact, some wills for HNW individuals with many children and other beneficiaries establish multiple testamentary sub-trusts to multiply this tax-saving opportunity after death.

Insurance

That said, even where the tax on death has been deferred and minimized, there'll be a tax burden to satisfy at some point, and the family will have to plan for that eventual liquidity call. Creative insurance strategies—such as joint-last-to-die policies that pay the death benefit on the second-to-die of the spouses or life-insured annuity contracts that provide the necessary liquidity at the right time—can be put in place to provide tax-sheltered investment return, estate preservation and liquidity to pay the ultimate tax burden.

There are also interesting insurance strategies for investment-holding companies.

If the insurance policy is owned by the corporation, the death of the insured will trigger payment of the death benefit. Most of this death benefit is added to a surplus account that can be distributed to shareholders on a tax-free basis. And if the insurance proceeds are used to redeem or buy back shares held by the estate, the insurance can be used not only to fund the tax payable on death, but also to reduce the net tax payable, leaving more insurance money for the estate beneficiaries.

Keep in mind, though, that this redemption planning must be completed within the first year following the death of the insured person.

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Charitable Focus

by **Laura Busch**

Sandra Pierce felt as if there was something important she had yet to accomplish. At age 50, she was a successful Toronto financial advisor, but she still felt as though she hadn't done enough.

"It's scary turning 50," said Pierce, senior vice president and investment advisor at Macquarie Private Wealth. "You start taking inventory of your life. 'What have I done that's worthwhile?' "

During her 25-year career, Pierce has continuously urged her female clients to be more financially independent. She's long fought what she calls "the bag lady syndrome," a notion common among women clients that they'll one day run out of money, irrespective of how wealthy they are (see "Bay Street's Bag Lady," Advisor's Edge, September 2009).

"At 70, I wanted to look back and not regret not having done something philanthropic," said Pierce. "I have always been inclined that way. I always wanted to change the world."

That desire kicked off a year-and-a-half search to find the perfect charity with which to partner. Pierce had been involved with fundraising for AIDS in the 1990s and the cause remained close to her heart. But deep down she was seeking something that would promote female empowerment.

"If you look at Home Depot, it doesn't make sense for them to do AIDS fundraising; they're with Habitat for Humanity." Pierce was seeking a similar extension, and found that balance between head and heart when she learned about Because I Am A Girl, a program created by Plan Canada that invests in girls in impoverished communities.

It all clicked when Pierce connected a tool she'd used to appeal to women clients—high-end handbags filled with materials about her firm—with an idea for a fundraiser to connect philanthropically minded women with a cause they could relate to intimately. So was born The Power of the Purse, an event which took place April 14th at Holt Renfrew in downtown Toronto.

"I thought, 'This is it,' " said Pierce. "I'm the Bag Lady and that's about empowering women with finance. I have to be about empowering young girls through micro finance and education. And that's how I knew I would make a difference." The event brought together Pierce's clients for an evening that captured the essence of Because I Am A Girl and raised funds for a girl's school in Tanzania.

Seating at The Power of the Purse—at a long table in a beautifully appointed, slender room—put everyone first among equals and displayed the clout of women and wealth. It also let the attendees share reactions to speakers who enlightened them on the power behind such fashion icons as handbags and high-heeled shoes, while keeping them focused on the need to bring financial empowerment to women worldwide.

Attendees never lost sight of the fact that they were there to raise money for girls in other countries. And funds raised through the $250 ticket price were combined with proceeds from a silent auction that included handbags, a gown, and statues by an artist from Zimbabwe.

"Women in philanthropy have become incredibly powerful over the years," Pierce says. "We're an incredible force and we're just coming into our own."

What's more, her firm, Macquarie Private Wealth, is very philanthropically oriented and strives to match gifts from efforts initiated by employees. "So, what's so beautiful about that is that what I raise at the Power of the Purse fundraiser will be matched by the Macquarie Foundation," notes Pierce.

Roots of a charity

Because I Am A Girl started out as an academic report created by Plan Canada in 2007 which examined the plight of girls around the world. It found young girls in impoverished nations were discriminated against both because of their gender and because of their age. Furthermore, the report said that by investing money in girls, donors ultimately can make a larger impact in the community.

"Ultimately, girls can lift their communities out of poverty," said Paula Roberts, executive vice president, marketing and development for Plan Canada. "This starts in a very simple way. If you empower a girl, it's proven that she will invest 90% of her income back into her family. And while it's never fun to compare, a boy or a man would invest 30% of his income back into his family. So, in taking care of the girls, because they reinvest in their families, you are also taking care of the boys."

Because I Am A Girl aims to spread this message throughout the developed world to raise awareness. And with very little funding to support an ad campaign, this message has taken off—mostly through the help of social networking sites such

Charitable Focus *(cont'd)*

as FaceBook and Twitter. The Web site, which was launched in September, has so far exceeded 108,000 unique visitors and that number continues to grow.

Micro finance

Micro finance is an important part of what Plan Canada does in all its programs. Instead of going into a community with a large amount of money and quickly building lots of infrastructure, Plan's tactic is to stay in communities for 10 to 15 years and slowly teach people how to make money for themselves.

"Imagine that a community of women will come together, perhaps they have some type of cottage industry; typically that would be some type of handicraft," said Roberts. "And then you teach them about forming a community bank. A community bank can often be something as simple as a box that has money in it that's shared. That group will then get together to talk about the investments that they want to make in their handicraft business."

It's a fairly simple premise, but one that many women in developing countries know nothing about.

"Many of these grown women have never dealt with money whatsoever," said Roberts. "So, you're teaching them the fundamentals. You're teaching them about building a business on their own, the independence that will offer, the idea of saving and borrowing, the idea of spending less than you make in the end to garner a profit, and in turn investing that in making the community a better place."

Dollar matching

When donating to a charity, it's extremely important to know where your money is going. Equally important in many ways is to know if there are any dollar-matching programs attached to a client's charity of choice. When they are, every dollar donated can quickly turn into two or three dollars invested in the program.

The Canadian International Development Agency funds many different programs and services in developing countries. "The Canadian government has made a commitment to the developing world, and they have a very specific set of priorities and go through an incredibly rigorous process to identify organizations, including Plan, which are best able to do this delivery on their behalf," said Roberts.

If a proposal is approved by CIDA, it requires the charity match between 15% and 25% in private funding. That means if CIDA were to give a project $15 million, there would have to be about $5 million in private donations.

Making great philanthropists

Financial advisors, as well as anyone involved in the financial industry, have an intimate knowledge of how money works and how to create maximum impact when deploying a client's money. For this reason, advisors who choose to be involved in charity work tend to look for different things than average philanthropists.

"I think that for financial advisors, if I'm going to be engaged in that industry and I have a philanthropic heart, that it's all about impact," said Roberts. "Furthermore, if you're a female involved in that business, I think we're all bound together by a sisterhood and you get to feel like you're supporting someone who is a woman just like you are."

Pierce agrees: "I think philanthropy is important in any business. I think it's our social obligation. I also think that we're in a business where we make a very good income and everybody should give back."

While she doesn't believe having a background in financial advising makes charity work any easier, Pierce does say her career has equipped her with the tools needed to be an effective fundraiser. "I do know that if you're an advisor, you've had to build your business; you've had to prospect," she said. "And that's no different than fundraising. You have to be able to ask, and prospect, and go to strangers to say, 'Can you help me?' "

She notes the time constraints of the advisory profession had some impact on her setting philanthropic objectives. "I wasn't philanthropic until I was in my 50s because you just don't have time," Pierce says.

But now that she's developed the passion, she's charging ahead—the work on Power of the Purse accounts for 600 to 700 hours of her time, and she's looking to make the event annual.

"This is my life's calling," she says. "And what am I good at but raising money? I have access to it and I'm good at it."

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Laura Busch is a Toronto-based writer.

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Unlocking wealth for business owners

by **Mike George**

While many business owners have generated significant wealth, their investments are often inaccessible – locked up in their corporation for tax-planning purposes. At some point, however, the business owner may want to liberate those assets, and how he or she does so will significantly impact after-tax cash flow.

Most of the clients we see have corporations in place. These include a lot of holding companies that contain significant tax-trapped cash or investments. This can be the result of having sold assets of an operating company or simply from years of taking advantage of lower corporate tax rates. The number of corporations out there has increased too, thanks to recent legislation allowing certain medical professionals, lawyers, accountants and others to incorporate their businesses.

Along the way, though, and particularly at retirement, it'll eventually become necessary to work with the client's other professional advisors to look at ways of pulling that money out.

How you go about doing this needs to be part of a larger plan. Business owners need professionals on their side who work together in a coordinated way. Advisors need to be aware of shareholder agreements, corporate structures and certain corporate tax balances such as the capital dividend account. It's also necessary to adopt a left hand, right hand approach to working with the client's external professionals, ensuring all involved are working towards a common goal.

We recommend you work with the client's other professionals to get this education and understanding. Overall, complex corporate tax rules and structures mean there are no rules of thumb to refer to when planning to withdraw assets on a regular basis or when winding up a corporation.

Eligible dividends

In 2006, for example, changes governing the taxation of certain dividends altered how a lot of business owners were paid from their corporations.

Under the old system, income retained in excess of the small business limit it resulted in double taxation. The overall tax paid by the company, plus taxes paid by the shareholder, would be more than if the shareholder had earned it directly. Under the new regime, where income is retained in excess of the small business limit and eventually paid to the shareholder as an eligible dividend, the overall taxes should be approximately the same as if the shareholder earned the income directly.

This change in tax policy means there's a lot more money being retained inside corporations. How much the company is able to distribute this way is based on some pretty complicated calculations. Missteps can result in rather large tax penalties on the excess payments, which is why it's necessary to develop a close relationship with the client's corporate accountants.

Capital dividend account (CDA)

Another area, one where an advisor's planning will almost certainly have an impact, is related to the company's capital dividend account. Again, without working with company accountants, the impact you can have might not always be a positive one. Remember:

Companies only pay tax on 50% of the capital gains they realize and pay no tax on life insurance; The capital dividend account tracks the different tax-free amounts accumulated by a private company, so the company can eventually distribute these amounts to shareholders in the form of a tax-free capital dividend;

Capital losses reduce the CDA and the amount available for distribution; and Accidentally paying out a capital dividend in excess of the CDA balance can result in steep penalties.

Timing is everything

When clients decide to retire, many want to wind up their companies right away. Sometimes this is an emotional thing where they'd simply like to close up shop or deal with their taxes today, rather than leave a looming tax bill for their estate.

Consolidating assets is important to some people as well. Others can be put off by the expense and effort required to maintain a holding company. The higher tax rates on investment income earned inside a corporation can also be a deterrent.

Unlocking Wealth for Business Owners *(cont'd)*

Each client's situation is unique, and requires the client's professional advisors to weigh the different options available. Holding investments inside the corporation can help some clients avoid Old Age Security clawbacks, minimize their U.S. estate tax exposure or provide an opportunity for income splitting and estate planning.

In addition, once children are beyond the age where kiddie taxes apply, dividends may be paid to them as shareholders for college and university costs while they are still low-income earners. Finally, using corporate assets to purchase corporate-owned life insurance may provide a tax-efficient way of leaving an estate to the next generation.

Timing is also critical when it comes to maximizing the use of the $750,000 capital gains exemption. If the company is expected to grow, a client may want to consider an estate freeze to bring in other family members as new shareholders, who can make use of their $750,000 capital gains exemptions as well. This planning needs to be put in place long before the client wishes to sell the business. There may also be some opportunity to utilize trusts or develop shareholder agreements to prevent spouses (especially in the event of a marital breakdown) from being shareholders of the company.

When having any of these discussions with clients, it can be tempting to jump straight to a tax or investment analysis. Like other financial planning issues, finding the most efficient way to get money for the client needs to start with a careful analysis of the client's current situation and identification of their longer-term goals and objectives before moving on to the options available.

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Mike George is director of the Wealth & Estate Planning Team at Richardson GMP Limited, a coordinated group of in-house experts and professionals tasked with the job of providing support to advisors to ensure clients have complete and comprehensive estate plans in place.

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FASCINATING FACTS

Statistics Canada recently reported 2009 charitable donation figures:

- Total number of donations decreased by 200,000
- Total amount of donations decreased 5.4% to $7.75 billion
- Median amount of donation was $250
- Average age of donors was 53
- Average age of Alberta donor was 50, median donation was $370
- Nunavut had lowest number of donors, median donation was highest at $500

Alberta ranks 4th in Canada in the proportion of income given to charity

The decline in Albertan's generosity has occurred even as the province increased the tax credit in 2007 for charitable donations above $200 to 50%. On a donation of $1,000 the combined federal and provincial credit is now $450.

Generational Transfer of Wealth

According to a 2010 RBC Wealth Management study, 58% of Canadian millionaires think their children face challenges in managing their finances and 49% don't have confidence in their children's abilities to manage their inheritance. Although 67% feel it is their responsibility to preserve wealth for future generations and leave their children with a healthy legacy, 39% have no estate plan to speak of.

Albertans, ranked 4th, aren't as generous as others in Canada

The Fraser Institute reports that in 2008, just 24% of Albertans gave to charity. That's above the national average, but below Ontario, Saskatchewan and Manitoba.

Canadians increasingly prefer to donate online

An Angus Reid survey found that on average, 22% of Canadians prefer to donate online and 31% of Canadians aged 18-34 say online donations are their preferred method.

Canada ranked 3rd in global generosity based on World Giving Index

Based on charitable behaviour including giving money, giving time and helping a stranger, Canada ranked 3rd in global generosity in 2010 amongst 153 countries comprising 95% of the world's population. The study also found that being happy is more of an influence on charitable giving than being wealthy.

Brace Yourself for Happiness

From the February 2011 Cygnus Donor Survey…*Where Philanthropy Is Headed in 2011,* among 22,000 donors surveyed in North America, 79% plan to give the same or more to charitable causes while only 7% will give less. Among that 79%, one in every three donors will give more.

Recommended Reading

Taking Philanthropy Seriously
Beyond Noble Intentions to Responsible Giving
Edited by William Damon and Susan Verducci

A year of LIVING dangerously –
Dispatches from the front lines of philanthropy
By Lawrence Scanlan

How the rich can save the world
Philanthro – capitalism
By Matthew Bishop and Michael Green

The Ultimate Gift
By Jim Stovall