The Institute for Advanced Financial Education

COMMENT

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MULTIPLYING THE CAPITAL GAINS EXEMPTION

Families with qualifying property often consider structuring their affairs in ways that allow for the multiplication of the capital gains exemption. By utilizing all family members' available exemption when a business is sold, the overall income tax liability can be reduced across the family unit, leaving more after-tax capital.

In short, the capital gains exemption is a tax savings opportunity that allows individuals to shelter a certain amount of capital gains income under certain conditions.

Assume, for example, that an individual sells his or her shares of a corporation and the shares meet the qualifying conditions for claiming the capital gains exemption. The business owner has never claimed any capital gains exemption and neither have nine family members.

The chart below illustrates the tax savings arising from the multiplication strategy on the sale of a business that results in a $10,000,000 capital gain, and the significant impact on a family's wealth. When only the business owner is involved, the after-tax cash retained is $7,716,728, whereas this amount increases to $9,667,280 when nine family members are added into the mix.

		Business Owner Alone	Business Owner and 9 family members
Proceeds of disposition	A	$10,000,000	$10,000,000
Less adjusted cost base	B	Nominal	Nominal
Capital gain (A-B)	C	$10,000,000	$10,000,000
Taxable capital gain (50% of C)	D	$5,000,000	$5,000,000
Capital gains deduction (50% of the capital gains exemption)	E	$433,456	$4,334,560
Exposed to taxation (D-E)	F	$4,566,544	$665,440
Potential tax liability (50%)	G	$2,283,272	$332,720
Cash retained (A-G)	H	$7,716,728	$9,667,280

One of the more common techniques to achieve this result is for the business owner to freeze his or her position in the operating company by exchanging common shares for fixed-value preferred shares, with a family trust subscribing for new common shares of the operating company. The family members are beneficiaries of the trust. The common shares will grow in value as the company grows, and the total value of the company is represented by the combined value of the original owner's fixed-value preferred shares and the common shares owned by the trust.

If the company is subsequently sold, the vendors would be the original owner together with the family trust. Both the original owner and the trust will realize a capital gain on the disposition of the shares.

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Depending on the terms of the trust document, the trustees may choose to allocate the trust's taxable capital gain across all or a series of beneficiaries of the trust. Each beneficiary who receives an allocation is responsible for reporting their allocated taxable capital gain and claiming the capital gains deduction to minimize their income tax liability.

This type of multiplication strategy was the subject of a recent court decision where the Federal Court of Appeal upheld a decision by the Tax Court of Canada.

The facts of the case are as follows:

- In 2004, Daniel Laplante and his two partners froze their interest in DTI, and each established a family trust that subscribed for common shares of DTI.
- The beneficiaries of Mr. Laplante's family trust were Mr. Laplante and 16 of his family members.
- In 2008, all of the shares of DTI were sold, and the trust realized a capital gain of $5,852,074, which resulted in a taxable capital gain of $2,926,037.
- The trustees allocated the taxable capital gain to Mr. Laplante and 10 other beneficiaries. The adult beneficiaries used their capital gains deduction to shelter their income from income tax. In a few cases, because of low personal income, some of the beneficiaries were subject to alternative minimum tax.
- When allocating the taxable capital gain, the trustees distributed cheques to the adult beneficiaries for amounts equal to each beneficiary's allocation.
- In this particular case, each of the beneficiaries immediately endorsed and returned their cheque to Daniel Laplante, the dominant trustee, and signed a deed of gift.

The case originated from an audit conducted by the Canada Revenue Agency (CRA), after which a reassessment resulted in an additional $2,593,412.50 of taxable capital gain being added to Daniel Laplante's 2008 personal tax return. The CRA's position was that the distribution by the trust and subsequent gift back to Daniel Laplante resulted in Daniel Laplante being entitled to the proceeds, and he should be taxed accordingly.

Daniel Laplante appealed his assessment to the Tax Court of Canada. The court heard testimony from the adult beneficiaries as to their understanding of the trust, the sale, the taxable capital gain, their allocation, the endorsement of the cheque and the deed of gift. The judge found in favour of the CRA, concluding that the transaction was orchestrated, and the allocation was designed to access the beneficiary's capital gains exemption without any true monetary transfer of proceeds to the beneficiaries. Instead, Daniel Laplante was the true beneficiary and ultimate recipient of the proceeds.

The taxpayer appealed the Tax Court of Canada's decision to the Federal Court of Appeal. The Federal Court of Appeal reaffirmed the Tax Court's decision.

The taxpayer subsequently sought leave to appeal to the Supreme Court of Canada, which was denied.

This case highlights an important consideration when using a strategy to multiply the capital gains exemption or other strategies that involve family members as beneficiaries of a trust. Any allocation to a beneficiary, including the taxable capital gain, belongs to the beneficiary and must be paid to that beneficiary. As demonstrated by this case, a strategy should not be used as a means through which to simply increase the tax benefits that flow back to the original owner.

MATURING AN RRSP

When it comes time to move from the accumulation phase to the payout phase, there are several maturity options available to holders of a registered retirement savings plan (RRSP). Individuals can design their retirement plans by combining different payout options and, in some cases, moving between options. While RRSP annuitants must shift to a payout option before the end of the year in which they turn age 71, annuitants can mature some or all of their RRSP earlier than age 71, if they wish.

The basic options for maturing an RRSP include:

- Deregistering the RRSP;
- Purchasing a registered annuity with the proceeds of the RRSP; or,
- Converting the RRSP to a registered retirement investment fund (RRIF).

Under the registered annuity and RRIF options, the annuitant can enter into a contract at any time during the year they turn 71 and have the first payment deferred into the following year.

Deregistering a regular RRSP means withdrawing funds from the plan, with the value of the funds withdrawn included in the annuitant's income in the year of withdrawal. As such, the income will be subject to income tax in the year of withdrawal and will be taxed at the annuitant's marginal rate of tax. This type of deregistration can be done as a single lump sum amount or can be systematically withdrawn over several years. A strategy of this nature might make sense for small RRSPs or for individuals under age 71 who may need to access the funds from time to time but who do not want to be tied to the minimum annual withdrawal associated with a RRIF.

Deregistration is the default maturing option when an annuitant does not elect to take the RRIF or annuity option by the end of the year in which the annuitant turns age 71.

The registered annuity option has many possibilities that can allow customization to specific client situations.

- The annuity payment can be paid for the lifetime of the annuitant or the joint lifetimes of the annuitant and his or her spouse or common-law partner.
- The annuity payment can be structured to reduce on the first death of the joint lives or reduce upon the death of the annuitant spouse.
- The annuity can be designed with a guaranteed minimum number of payments that would be paid or commuted should the annuitant pass away before all guaranteed payments are made. The maximum guarantee period is 90 minus the annuitant's age.
- The annuity can be for a fixed term to age 90. If the annuitant survives to age 90, the annuity ceases. If the annuitant passes away before reaching age 90, the annuity could continue or be commuted, depending on the circumstances.
- The annuity payments are normally designed as equal amounts, but the periodic annuity payment could be designed to vary annually based on the interest rate assumed for pricing, changes in Consumer Price Index or a fixed increase of up to 4 percent.

The annuity option is a permanent decision; once purchased, annuitants cannot change their mind if circumstances change.

The RRIF option can provide RRSP annuitants with flexibility in meeting their needs over their retirement years.

A RRIF requires that annuitants withdraw a minimum amount annually from the plan, based on a prescribed government-mandated schedule; however, annuitants are not limited to the minimum but can withdraw as much as needed at any time. Any RRIF withdrawal is subject to tax at the annuitant's marginal tax rate.

The minimum amount that must be withdrawn annually from a RRIF is the fair market value of the RRIF at the beginning of the year (January 1) multiplied by the pre-set factor that aligns with the annuitant's (or annuitant's spouse's) age at the beginning of the year. When establishing the RRIF, annuitants may elect whether the annual minimum rate is based on their age or the age of their spouse or common-law partner. The annuitant also chooses the schedule for payments, such as monthly, quarterly, semi-annually or as a single annual payment.

RRIF Minimum Payment
Age at Start of Year

Age	Factor	Age	Factor	Age	Factor	Age	Factor
60	0.0333	70	0.0500	80	0.0682	90	0.1192
61	0.0345	71	0.0528	81	0.0708	91	0.1306
62	0.0357	72	0.0540	82	0.0738	92	0.1449
63	0.0370	73	0.0553	83	0.0771	93	0.1634
64	0.0385	74	0.0567	84	0.0808	94	0.1879
65	0.0400	75	0.0582	85	0.0851	95	0.2000
66	0.0417	76	0.0598	86	0.0899	96	0.2000
67	0.0435	77	0.0617	87	0.0955	97	0.2000
68	0.0455	78	0.0636	88	0.1021	98	0.2000
69	0.0476	79	0.0658	89	0.1099		

Assume, for example, Aisha's RRIF has a balance of $100,000 on January 1, 2019 and that she is 80 years old at the beginning of the year. The minimum payment Aisha must receive from the RRIF in 2019 is $6,820 ($100,000 x 0.0682). She must receive the $6,820 before the end of 2019 but may withdraw any amount she wishes, provided it meets or exceeds the minimum.

An individual can start with a RRIF and then, years later, use the RRIF to buy an annuity. This strategy could work for individuals who prefer a high degree of investment control during the early years of retirement but want to insure against the risk of longevity later in their retirement.

An individual can decide to change RRIF carriers at any time. In such a situation, the first RRIF carrier ensures that the RRIF minimum payment to the annuitant is paid for the year. The new RRIF carrier is not obligated to make a RRIF minimum payment until the following year. This approach is taken because the new RRIF carrier does not have a beginning of year balance on which to base the minimum.

Most payments made to the annuitant under any of the options are subject to withholding of income taxes at source, which would be remitted to the CRA. The annuitant reports the gross amount of income and claims the taxes withheld at source when filing his or her annual personal tax return.

The only payment that is not subject to withholding of income taxes at source is a RRIF payment based on the annual minimum. Annuitants who chose the annual RRIF minimum will not have income taxes withheld at source, but the income is still fully taxable at the annuitant's marginal rate of tax. As such, a reconciliation of taxes owing on the annuitant's RRIF income occurs when the annuitant files an income tax return.

The legislated rate of withholding for the deregistration option and RRIF payments in excess of the minimum is outlined below.*

- Up to $5,000 — 10%
- $5,000 to $15,000 — 20%
- Over $15,000 — 30%

*Excludes Quebec, which has a separate schedule.

Assume, for example, that Sarah expects to draw $4,000 per month from her RRIF this year, when her annual RRIF minimum is $6,000.

The carrier would withhold $1,050 from each monthly payment (30% x ($4,000 less ($6,000 ÷12))). Sarah would report $48,000 of RRIF income and $12,600 of taxes withheld at source.

Annuitants can request that more than the minimum amount be withheld at source. This can be helpful for individuals who do not like to have a large payment due when filing their personal return or who have difficulty saving throughout the year.

Planning Strategies

Individuals might want to RRIF a portion of their RRSP at age 65 in order to generate sufficient eligible pension income to enable them to claim the pension income credit. The analysis should consider the extra tax paid on the RRIF payment compared to the tax savings arising from the claim for the pension income credit.

Individuals might want to RRIF a portion of their RRSP at age 65 in order to generate enough eligible pension income to split with their spouse. The RRIF annuitant can elect to share up to 50 percent of their RRIF income with their spouse and have that portion reported by the spouse on their tax return. The spouse would also be entitled to the pension income credit if they are age 65 or over.

Understanding the breadth of options allows taxpayers to custom design a plan that best suits their needs.

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