KNOWLEDGE EXPECTED OF: CFP® Professionals Only

Version 1.0.1, Updated 20171206

Omar and Althea are parents to 12-year-old twins. Omar also has two children from a previous marriage–January, age 22, and June, age 19.

Omar is the sole shareholder of a Canadian manufacturing corporation that exports 80 percent of its finished goods to international markets. Revenues topped $2 million for the first time last year, enabling Omar to double his salary to $150,000. He projects the same level of income until he retires.

The business has grown steadily over the last 15 years since Omar`s first wife, and shareholder in the company, passed away. After taking some time away from the business at that time, he used one quarter of the life insurance, payable to the corporation, to expand the business. He used the remainder to invest in a corporately-held investment account for retirement. The current balance of the investment account is $550,000, including a mix of equities and fixed-income investments.

Given the demands of the business, Omar plans to hire January once she graduates from post-secondary education later this year. He would like to transfer the business to January in about five years. By then, he expects that he and Althea will be ready to retire and spend time from January to March each year in Arizona. The couple will be reliant on the value in the business and Omar's Registered Retirement Savings Plans (RRSPs) to help fund their retirement. Althea does not have an RRSP of her own.

Althea works part-time as a personal tax preparer. She earns the greater part of her $35,000 annual income between February and May. During the remainder of the year, she raises the couple's children, while doing the bookkeeping and tax remittance for Omar's company. During the busy tax season, she employs the help of June to babysit the twins while she works.

Omar would like to discover tax-efficient ways to draw income from his corporation, and increase his family's overall after-tax income.

Knowledge Expectations – Tax Planning

The CFP professional should be able to:

- Explain that Omar can increase his family's after-tax income by taking advantage of all relevant personal tax deductions and credits.
    - RRSP: Explain that Omar may increase his family`s after-tax income by contributing to an RRSP. Omar may consider making his contributions to a spousal RRSP in Althea's name. This will enable him to receive a tax deduction at his marginal tax rate, while providing the opportunity to withdraw the funds in retirement at Althea's lower marginal tax rate.

  - Child-care deduction: Explain that Omar and Althea may consider paying June for her babysitting services. If June issues a receipt for reasonable wages to take care of the children, Althea may claim the expense as a child-care deduction. This will enable Althea to lower her taxable income. The added benefi t to June is that issuing a receipt for her services builds her RRSP contribution room.

- Explain that Omar should consider contributing to a Registered Education Savings Plan (RESP) for his twins to take advantage of tax-deferred growth within the plan, and the Canada Education Savings Grant (CESG).

- Explain that, after maximizing his contributions to an RESP for his children, Omar may also consider investing a portion of his income in a Tax-Free Savings Account (TFSA), to earn tax-free growth on his investments. Given that he has not contributed to a TFSA previously, Omar can contribute up to $46,500 (as of January 1, 2016) to the plan. Additionally, he may consider gifting up to $46,500 to Althea to contribute to a TFSA in her name, enabling the couple to double the amount they can shelter from tax. Similar to the funds in a spousal RRSP, any funds contributed to the TFSA in Althea's name become her property.

- Explain that the family's personal tax bill may be lowered by paying Althea a salary for her bookkeeping services. The Canada Revenue Agency may allow the salary to be taxed at Althea's lower marginal tax rate so long as the remuneration for the work done is deemed reasonable. Similar steps may be taken when January joins the organization.

- Explain that Omar may consider consulting with his legal and tax specialists regarding a possible restructuring of the business, which would see the inclusion of Althea and January as shareholders. This way, the corporation would pay them a salary, as well as any dividends, taxable at their lower marginal tax rates. And, since each shareholder may qualify for the capital gains exemption, a greater part of the share growth would be sheltered from capital gains tax. A corporate restructuring might also enable a tax-efficient transfer of his shares to January in five years' time. If contemplating a restructure, Omar should make the effort to ensure that he maintains control of the corporation.

- Explain that Omar may consider appointing Althea and January as corporate directors of the corporation, for which they may earn a director's fee.

- Identify that Omar may have the opportunity to draw tax-free income from his corporation's capital dividend account (CDA). Some funds may be available in the CDA based on life insurance proceeds payable to the corporation upon the death of his first wife, and the tax-free portion of capital gains earned in his corporate investment account.

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- Omar is seeking advice regarding the best way to draw funds from his business. Explain that he may wish to draw tax-free capital dividends first. Also, while salary is fully taxed income, it provides Omar, Althea and January the opportunity for earned income and RRSP contribution room. RRSP contributions enable tax-deferred growth until retirement. Salary also contributes to credits toward Canada Pension Plan (CPP) income and other benefits. While regular dividend income will enable Omar, Althea and January to earn income more tax-efficiently, it must be weighed against the benefits associated with salary. Omar should consult with his tax specialist each year to identify the optimal amounts of dividends and salary that he, Althea and January should draw from the corporation each year.

- Explain that, in order for Omar to transfer his business tax-efficiently at retirement, he will need to ensure the following: for the 24 months preceding the disposition of the shares, more than 50 percent of the assets' fair market value in the corporation is actively used in a business run in Canada; and that, at the time the shares are disposed of, a considerable part, or 90 percent of the corporate assets' fair market value, is being used in an active business in Canada. Since the corporation has passive assets in the form of investments, Omar should consult his tax and legal specialists about the options to help meet these requirements. Options include paying dividends and/or setting up a holding company to hold the passive investment assets. A holding company may also enable Omar to protect these assets from creditors of the manufacturing business.

- Identify that, based on Omar and Althea's expected duration of stay in the United States, they will likely not be considered U.S. residents[1] for tax purposes. This means that they will be able to avoid the possibility of double taxation, and PFIC rules that might create tax implications for income earned in the couple's registered plans and non-registered investment accounts. It also means that they will avoid any detailed continuous reporting requirements related to the assets they own.

[1] The substantial presence test can be used to determine this. The couple is expected to spend 90 days per year in the U.S. Under the following formula, 90 days + 1 / 3(90 days) + 1 / 6(90 days) = 145 days; this is fewer than the 183 days during the three-year period required to be considered a U.S. resident for tax purposes.

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