ROSEDALE
FAMILY OFFICE

# Pre-budget tax and estate planning – what should I be considering

March, 2021

On March 8, 2021, the Federal Liberal Government announced that they are ruling out releasing the Federal Budget this month but plan to table the Budget at some point in Spring. This means that it will be more than two years since the Federal Government tabled its last Budget on March 19, 2019 – given that the originally-scheduled March 30, 2020, Budget was delayed due to COVID.

In our daily discussions with clients, there are certain common questions that arise. *Are tax increases coming* is certainly at the top of the list. Although we do not have a crystal ball, we would suspect the answer to this question is “most likely” - given that the Federal government has made their intentions clear of targeting the ”1%”, etc.

The follow-up question is “what can we do now” to defer or save taxes? Enclosed are a few strategies which may help in lowering your family’s tax bill. Ultimately, what planning is available and effective will depend on your specific facts and circumstances.

These comments are not intended to provide formal tax or legal advice but are merely for awareness purposes.

## 1. Capital Gains Planning

There is significant speculation in the tax and business community that the Government may increase the capital gains “inclusion rate,” which is the portion of a taxable capital gain.

As a brief historical background, the inclusion rate has varied over the years. From 1972 to 1988, the inclusion rate was 50%. The inclusion rate increased to 66 2/3% in 1988 and 1989, and then it jumped up to 75% from 1990 to February 27, 2000.

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In 2000, the inclusion rate decreased twice (from 75% to 66 2/3%, and then down to 50%) - where it has remained unchanged at 50% since October 17, 2000.

If you believe that the capital gains inclusion rate may increase, what should you consider doing?

- *Consider disposing of assets today to "lock-in" / crystallize the 50% inclusion rate*

One strategy may involve simply selling the securities now (especially if you are planning on liquidating them in the near-term future) to "crystallize" the gain at the current 50% inclusion rate. This strategy's rationale assumes that any future rate change will be effective on or after Budget Day. Thus, if you have triggered gains at the current 50% rate, you will have "saved" the incremental tax otherwise owing if you were to have sold the assets AFTER a potential rate change (when the inclusion rate could be 75%, for example).

The downside of this strategy is that if the inclusion rate is unchanged, you may have accelerated your tax bill prematurely.

- *Transfer appreciated securities to a holding company*

Another more sophisticated strategy involves transferring assets (with unrealized capital gains) into one's private corporation using an S.85 tax election ("S.85"). An S.85 allows one to elect a transfer value between its tax cost and FMV in exchange for shares with the same attributes. Given the filing deadline of the S.85 tax election, if the capital gains inclusion rate is increased, you may be able

to elect to trigger the unrealized gain and be subject to the "old" 50% inclusion rate. If there is no change to the inclusion rate, then you may simply elect to transfer the security at its tax cost (i.e., on a tax-deferred "rollover" basis and thus not trigger any gains for now).

It is important to note that although this strategy provides additional flexibility, there are professional fees involved and other considerations in implementing it. Moreover, without proper planning, there is the potential for "double tax" when a shareholder dies holding private company shares. *Post-mortem tax planning* strategies may be considered to mitigate this double tax burden.

- *Corporate Surplus Planning*

As a consequence of the personal tax rates increasing over the years, the "spread" between dividend rates and capital gains rates has grown. Accordingly, planning has developed whereby a taxpayer creates a capital gain to extract corporate funds at tax-preferred *capital gains rates*, as opposed to higher-taxed *dividend rates*.

As an example, for a top-rate Ontario resident individual shareholder, the tax savings could be ~20% by accessing corporate funds by way of a capital gain vs. receiving a non-eligible dividend.
This is very technical planning which may attract CRA scrutiny. The CRA had attempted to "close" such planning strategies in its July 18, 2017 "Consultation Paper" but ultimately backed-away from these proposals. It is generally agreed in the tax community that there is a limited "window of opportunity" for taxpayers to consider this planning before a future Federal Budget changes the tax law to eliminate the benefits of this strategy.

## 2. **Prescribed Rate Loan Planning**

This technique involves making a loan (usually cash) to a spouse or a Discretionary Family Trust. The individual making the loan is required to charge interest at the minimum of the prescribed rate in effect at the date the loan is made.

Effective July 1, 2020, the CRA announced that the "Prescribed Rate" would be 1% (down from 2%) effective for Q3 2020. The Prescribed Rate currently remains unchanged at this low 1% level.

*Income splitting* is achieved by having investment income "shifted" and taxed in lower family member's "hands" at their graduated marginal tax rate. i.e., the difference between the investment return and the prescribed rate of 1% is effectively taxed in the lower-income earner's hands. Such *Prescribed Rate Loan Planning* can be a potent planning tool to help fund family expenses – such as paying for private school, summer camp, extra-curricular activities, etc.

To learn more about this strategy – click here to read our article titled *Opportunity to Income Split and Save Taxes on Investment Income.*

## 3. **Estate Freeze / Re-Freeze**

For business owners who hold "growth assets" (e.g., shares in an operating business), the Corporate "Estate Freeze" is another strategy that may be beneficial.

Under Canadian tax law, when an individual dies, they are generally deemed to dispose of all of their assets at FMV. This "deemed disposition" may trigger a capital gains tax bill. If there is a surviving spouse (or a Testamentary Spousal Trust), the tax bill may be deferred to the second spouse's death. However, ultimately this "estate tax" will be payable – without proactive planning.

The *Estate Freeze* effectively involves "freezing" a family member's "growth" assets (e.g., common shares) and exchanging the shares, on a tax-deferred basis, for "frozen" / fixed-value preferred voting shares. We typically introduce a family trust (which provides a degree of control) to subscribe (at a nominal cost) for non-voting "growth" common shares. The newly-issued "growth" common shares will accrue the future growth in the business. Ultimately, this future growth can subsequently be transferred to the freezor's desired beneficiaries (e.g., children and/or grandchildren via the family trust).

Key benefits of implementing an *Estate Freeze* include the following: deferring the future tax bill associated with the growth in order that it may be taxed in the hands of children and/or grandchildren at a later date; allowing for the potential opportunity to multiply access to the tax-free Lifetime Capital Gains Exemption ("LCGE"), provides flexibility for business and estate succession planning purposes; etc.

As we have clients who have experienced temporary declines in the valuation of their businesses, we are also working with these clients and their professional advisors to consider the merits of implementing a thaw and/or re-freeze.

To learn more, read our article titled Tax Planning in Volatile Times: Is Now the Time To Consider an Estate "Freeze" or "Refreeze"?

Lastly, it should also be noted that as part of our comprehensive planning process, we will consider the suitability and appropriateness of other planning strategies – including but not limited to the following:
*Structured Flow-Through Share Planning* to significantly reduce the after-tax cost of charitable gifting and/or as a tax management tool for individuals in the top marginal tax rate; *Life Insurance Planning* as a tax-efficient wealth transfer tool to grow and accumulate wealth on a tax-exempt basis; etc.

Takeaway
Please feel free to contact a member of *The Rosedale Family Office* if you would like to learn more about these strategies and how they may be incorporated into your own succession and legacy plans.