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Tax

Tax planning strategies in market downturn: Estate freezes, income splitting

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(June 2, 2020, 2:37 PM EDT) -- COVID-19 has had a severe impact on the global economy. The pandemic has caused emergency declarations across the world, major lockdowns of public and social life and a drop in markets that rivals the Great Depression. Supply lines have been cut, businesses shut down and unemployment rates have soared (currently 13 per cent in Canada). Individuals and businesses have been handed more lemons than they may know what to do with.

But as the old saying goes: when life gives you lemons, it's time for tax planning! Certain tax planning strategies offer significant tax savings and/or deferrals when implemented during periods of lower business and investment valuations. These strategies are often used by high net worth individuals, privately held owner/manager companies and family businesses in ordinary times, but can produce even bigger tax savings in market downturns. Certain other strategies are relevant for businesses to mitigate the impact of an economic downturn.

In this three-part series, we discuss select tax planning strategies that make use of the market downturn or otherwise mitigate its impacts. In this part, we will discuss estate freezes and income splitting, which are strategies that can capitalize on lower asset valuations and are particularly relevant for those wishing to engage in estate planning.

In part two, we consider various tax-efficient creditor proofing strategies that are worth considering due to the litigious environment of an economic downturn.

Finally, in part three, we will outline certain tax considerations relevant where businesses are in a tough economic climate, such as loss utilization and debt forgiveness.

The discussion in these articles is of a general nature only and we recommend that a professional tax adviser be consulted before implementing any of the strategies discussed.

Estate freezes

Under the Canadian federal income tax regime, when an individual dies, his or her capital property (which may include real estate and investments in public and private securities) is deemed to be disposed of for fair market value proceeds immediately before death. The deceased individual may therefore realize capital gains upon death resulting in tax payable on the individual's final tax return.

While there are certain exceptions to this rule (such as passing the assets to a spouse or common law partner or claiming the lifetime capital gains exemption to shelter the tax for certain property), the effect can be significant on intergenerational wealth transfers and business continuity.

An "estate freeze" is a commonly used tax planning strategy to mitigate the tax resulting from the deemed disposition on death. The strategy seeks to "freeze" the value of an individual's assets at a point in time so that the future growth in value accrues to the beneficiaries of the plan, such as the children or other relatives who wish to continue the business or utilize the assets after the individual passes away.

Here is an example of how an estate freeze might be implemented. Assume a parent is the holder of all of the common shares in a company that has a business or investments. The parent can exchange their common shares for fixed-value preferred shares with a value equal to the common shares exchanged. This transaction can be completed on a tax-deferred basis. Because the value of the preferred shares is fixed (subject to a preferred dividend entitlement), the parent has "frozen" his or her economic interest in the company.

The parent's children or other intended beneficiaries can subscribe for new, common shares for a nominal amount and benefit from any future increases in the company's value. Alternatively, a discretionary family trust can be used to subscribe for the growth common shares (with the children or other relatives as beneficiaries of the trust).

The parent can maintain control of the company either by owning the voting shares directly or by being the trustee of the trust that owns the votes.

The result is the capital gain realized by the parent on death will be reduced to the extent that the underlying assets have appreciated in value between the time the estate freeze is implemented and the parent passes away.

While the above example involves a parent's existing interest in a corporation, this is not the only situation where an estate freeze can be implemented. Estate freezes are often available for businesses and assets held in non-corporate legal entities or personally as well. But the assets typically have to be transferred into a company or perhaps a partnership such that the parent freezes his or her economic interest by taking back fixed-value securities.

There is no "one size fits all" form of estate freeze so the optimal structure will depend on the particular circumstances.

In summary, individuals who own assets that are expected to increase in value between now and the time of their death should consider implementing an estate freeze due to the current reduced market values. Those with an estate freeze already in place might consider a "thaw and refreeze" transaction, which effectively does a fresh estate freeze in order to take advantage of the lower fair market value. Lemons from lemonade is the name of the game.

Income splitting

Income splitting generally entails taking income that would otherwise all be taxed in a particular individual's hands and instead "splitting" it with family members (such as a spouse or minor children) in a lower marginal tax bracket. The result is that while the income remains within the family unit, the overall effective tax rate on it is reduced.

Canadian tax rules make it difficult to income split. The *Income Tax Act* contains "attribution rules" (rules that attribute the income from gifted property back to the transferor of the property) and the "tax on split income" or "TOSI" rules (rules that tax certain types of income at the highest marginal tax rates), which make income splitting difficult in most circumstances.

However, one area where income splitting is still permitted is on income and capital gains from publicly traded securities using a "prescribed rate loan." TOSI generally does not apply to income and gains on publicly traded securities. And the attribution rules will not apply providing the high income earner makes a prescribed rate loan to the spouse, minor children or a trust for their benefit.

A trust is often the preferred vehicle to make the loan to since the high income earner can retain some degree of control over the trust's investments and distributions to beneficiaries. Income and gains realized by the trust are allocated out to the beneficiaries and taxed in their hands at the lower marginal rates.

The prescribed rate loan means a loan that bears interest at the rate in effect (as set out each quarter by CRA) at the time the loan is made. The prescribed rate is currently two per cent per annum but is set to drop to one per cent per annum starting on July 1. The high income earner will have to include the interest on the loan in their income.

Importantly, the loan interest rate does not have to be increased if/when the CRA prescribed rate goes up; under the current rules, it is the rate in effect at the time the loan was made that applies indefinitely. Also noteworthy is that interest on the loan must be paid by Jan. 30 of the year following each year in which the interest accrued in order for the attribution rules not to apply.

To illustrate the strategy's potential benefit, an individual who does not have any other income can earn approximately $15,000 of interest, $30,000 of capital gains, or $52,000 of eligible dividends (or some combination of the three) each year while paying zero income tax. That can translate into potentially millions of dollars of tax-free income over time depending on the number of individuals the income is split with and the time period involved.

Given the reduced asset values of late and the low prescribed rate, income splitting using publicly traded securities acquired through a prescribed rate loan may be particularly enticing. Now is a great time to consider whether this strategy might work for you or your clients.

Bottom line

While one would rarely welcome sharp declines in asset or business values, it does present opportunities for tax and estate planning. Lemons from lemonade is what your grandmother called it; while she may not have had this kind of planning in mind, it can work about as well in many cases. Next week, we will explore some more strategies that would make Grandma proud.

This is part one of a three-part series.

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