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TAX LETTER

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ESTATE PLANNING AND ESTATE FREEZING

Overview

Estate planning encompasses a number of areas:

- You should have a will that takes into account both your desires and tax considerations.
- You may wish to consider steps to minimize probate fees (called Estate Administration Tax in some provinces) on your death.
- You should carry enough insurance to meet your family's needs on your death.
- If you hold assets in other jurisdictions or if you are a U.S. citizen, you must consider the effects of foreign estate taxes.
- If you are leaving assets to your children who are or may be married, you can plan around the provincial family laws that apply on marriage breakdown.

In this article we focus on the **tax aspects** of estate planning, and specifically on **"estate freezing"** techniques that can be used to reduce the tax cost of death.

Taxes on death

Canada has no estate or inheritance taxes, although provincial probate fees ("Estate Administration Tax", in some provinces) can be up to 1.5% of the value of your estate.

The primary *income tax* effect of death is a **deemed disposition of capital property** at its fair market value. All of your capital property (essentially, all property except inventory in a business) is treated as though you had sold it immediately before your death at its current value. Thus, any accrued **capital gains are recognized and taxed** in your final tax return, which is filed by your executor. At the same time, accrued capital losses are also recognized in your final tax return.

Capital gains are half-taxed, so the tax rate on such gains can be as high as 27%, depending on your province of residence. In planning for your death, if you have assets with significant accrued gains, you should assume that the tax resulting from the deemed disposition will be substantial.

One way of deferring the tax on your death is to leave assets to your **spouse** or a qualifying **spousal trust**. Provided certain requirements are met, the deemed disposition on death will be at your cost of the assets rather than at their current value, so there will be no tax to pay. That cost will then be "rolled over" (transferred) to your spouse, so that the tax deferred will in effect be paid on your spouse's death. (The same rules apply to a "common-law partner", if your common-law relationship meets certain conditions.)

Estate freezing

Estate freezing is the term used to describe steps taken to "freeze" some of your assets at their present value, so that *future* growth can go to your children or grandchildren and not be taxed on your death. It is most worthwhile if you have an incorporated business that is expected to grow significantly in future years, and in which your children are actively involved.

There are many different forms of estate freeze, and the appropriate one for you will depend on many different factors, such as: the value and nature of your assets; the expected growth of your estate; the number, ages and spousal status of your children; your age; the availability of the capital gains exemption; your and your spouse's financial needs, both now and on retirement; and many other factors including the new "Tax On Split Income" (TOSI) rules that took effect in 2018.

Below we describe just one example of an estate freeze.

> Example – a "Section 86" freeze
>
> This is the simplest estate freeze. Section 86 of the Income Tax Act allows an exchange of one class of shares in a corporation for another class with no tax consequences, as long as all of the shares of the first class are being exchanged.
>
> Suppose you run an incorporated business, XYZCo. The corporation has 1,000 issued common shares, all registered in your name. You originally invested $1,000 in the corporation ($1 per share), and the shares are now worth $200,000. You expect that in a few years they may be worth as much as $1 million. You have an adult daughter who works full-time in the business, and you want her to inherit it.
>
> If you simply leave your shares to your daughter in your Will, the deemed disposition on your death will trigger a substantial capital gain. If the shares are indeed worth $1 million when you die, your estate might have to pay up to $270,000 in tax.
>
> Let's look at how you can use an estate freeze in this situation.
>
> You **exchange** your 1,000 common shares in XYZCo for **1,000 preferred shares** (with share conditions that we'll explain below). Your daughter then invests $100 in 100 new common shares of XYZCo, at $1 each.
>
> The object is to "freeze" the value of your investment at $200,000, which is what the shares are worth now. Any increase in value above the $200,000 level will accrue to your daughter, and not to you. Therefore, your preferred shares need to be set up to have a value of exactly $200,000 – a value that does not increase even though the value of the company as a whole increases.
>
> However, you want to keep control of the business as long as you are alive.
>
> With this in mind, here is how you might design the preferred shares that you will own:
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> - The preferred shares will be **voting shares**. Each preferred share should carry 1 vote, and each new common share could carry 1 vote (although the common shares could be non-voting). Since you will have 1,000 votes to your daughter's 100, you can

elect the board of directors, and thus you will continue to control the corporation.

- The preferred shares should be **retractable**, at the option of the holder (you), for $200 each, or $200,000 in total. In other words, you will have the legal right to force the corporation to pay you $200,000 for your shares at any time. That makes it clear how much the shares are worth – since you can cash them in whenever you want.
- Preferred shares must pay a **dividend** in preference to the common shares. The dividend could be in the discretion of XYZCo's directors, or could be fixed at, say, $6 per year per share (i.e., 3% of their value), payable quarterly. The dividend can be made **"non-cumulative"**, so that if XYZCo chooses not to declare a dividend in any given quarter, the unpaid dividends will not accumulate to prevent dividends from being paid to your daughter on the common shares.

The specific details should be worked out with your professional advisers as part of your customized estate plan. Everyone's situation is different.

Now, what have you accomplished?

- First, because of section 86 of the Income Tax Act, there is no cost to exchanging your common shares for preferred shares. In other words, the $199,000 accrued gain on your shares isn't taxed for now. (The preferred shares take on the cost base of your original common shares, so they have a deemed cost to you of $1,000.)
- Second, you have "frozen" the value of your investment at $200,000, since the preferred shares will be worth only that much in the future. (They can't go up in value because of the fixed dividend.) So if the value of the business increases, the growth will be allocated to the common shares. On your death, if the business is worth $1,000,000, you have a capital gain of just under $200,000 instead of just under $1,000,000, so the tax cost is far less. (We're ignoring the capital gains exemption on small business shares for purposes of this example.)
- Third, you have kept control of the business. You can continue to elect the board of directors that hires employees and runs the company. And you can continue to be the sole director, if you wish.
- Fourth, if you need income, you can cause the directors of the corporation to declare dividends on the preferred shares, in addition to any salary, bonus or consulting fees the corporation pays you. Since the dividends are non-cumulative, you can also choose to have the corporation *not* pay them, as long as you are not paying dividends on the common shares during the same quarter.
- Fifth, if you ever need the capital, you can require the corporation to redeem the shares for $200,000. (This will result in a "deemed dividend" to you of $199,000, on which you will pay tax of up to about 40%.)

The possibilities are endless...

The above is only one example. Estate freezes can be much more complex, and can involve such features as: family trusts owning shares for your children; "section 85 rollovers" whereby you transfer shares or assets to a holding company; crystallization of the capital gains exemption on small business corporation shares; and many other techniques.

There are many technical traps and pitfalls in the Income Tax Act to watch out for, however. These include attribution rules, the Tax On Split Income, deemed dividends, stop-loss rules, surplus stripping rules, capital gains stripping rules, and others too numerous and arcane to mention.

If you have significant assets that are or can be incorporated, you should definitely explore ways of protecting your estate from severe tax costs on your death.

THE TAX COST OF LEAVING (OR LOSING) YOUR JOB

What happens for tax purposes if you leave your job – voluntarily or by being terminated – and your employer gives you additional money?

Typically, you might receive one or both of the following kinds of payments:

(1) An **extension of your salary** during a period while you are still officially employed. For example, you might be given 12 months' notice of termination, and your salary and benefits continue during that period – whether or not you actually continue coming to the workplace.

(2) A **severance payment**. For example, you might get 12 months' salary. This might come in one of several ways:

- Your employer offers you an "early retirement" package which you accept.
- You are fired and accept an offer of 12 months' severance.
- You are fired and you do not accept your employer's offer. Instead, you consult a lawyer, who threatens to sue your employer for wrongful dismissal. Perhaps you even start a lawsuit. You eventually reach a settlement, with your lawyer's assistance, and the employer pays you the equivalent of 12 months' salary.

- You are fired and you sue your former employer. The case does not settle before trial, and the Court awards you 12 months' salary for wrongful dismissal.

Payments of type (1) above, which continue your salary, are treated as regular employment income, and are given the same tax treatment as your salary was before you were given notice. The same withholding at source applies as well – tax withholding that is approximately equal to the amount of tax you will have to pay on this income. Tax also continues to apply on any taxable benefits that continue while you are still receiving salary.

Payments of type (2) above – whether simply offered by the employer (and accepted), paid to settle a wrongful-dismissal lawsuit, or awarded by the court – fall into the definition of what the Income Tax Act calls a **"retiring allowance"**. This term also covers a payment genuinely made in recognition of long service when you retire.

A "retiring allowance" is taxable, and must be included in income on your tax return. So in some respects it does not matter whether you get a continuation of salary or a severance payment. However, there are a number of important differences between a "retiring allowance" and regular employment income:

- If you began your employment with this employer (or a related employer) before January 1, 1996, then part of the retiring allowance can be **transferred to your RRSP** instead of being taxed this year. You can transfer up to $2,000 for each calendar year (or part of a year) during which you were employed with that employer (or a related employer) before 1996.

  As well, if you were not a member of a pension plan or deferred profit sharing plan to which your rights have vested, you can add an additional $1,500 for each such year during which you were employed before 1989.

  If the above money is transferred directly by your employer to your RRSP, then no tax will be withheld from the payment. However, if this is not done, you can still do the transfer yourself, provided you do it by 60 days after year-end (the same deadline as for regular RRSP contributions).

- A "retiring allowance" is ***not* considered employment income** for tax purposes. (Technically, it is taxable under section 56 of the Income Tax Act, rather than under the employment-income sections, which are sections 5, 6 and 7.) This means that it does not create RRSP contribution room (except for the pre-1996 employment described above), and does not count as "earned income" for purposes of the deduction for child-care expenses. It also means that you (and your employer) won't have to pay Canada Pension Plan / Quebec Pension Plan contributions or Employment Insurance premiums on the "retiring allowance", so if the payment is early in the calendar year when CPP/QPP and EI would be payable on employment income, a "retiring allowance" may be preferable.

- The **withholding tax** on the retiring allowance (other than any amount transferred directly to your RRSP as per above) is 10% for amounts up to $5,000, 20% of the total for $5000.01 to $15,000, and 30% of the total for $15,000.01 and over. (In Quebec, the withholding is 21%, 30% and 35% respectively.) This is only a prepayment of your tax; the actual tax you pay will be calculated on your tax return for the year by including the retiring allowance in your income, and you will receive a credit for the tax withheld. So if you are in a 50% tax bracket, you may need to set aside an additional 20% of the pre-tax amount to cover the tax you will owe next spring.
- If you become **non-resident** before you receive the retiring allowance, the only tax will be a flat 25% non-resident withholding tax, rather than the regular personal income tax at rates of up to 54%.

Is there any way to make the settlement tax-free?

Aside from the RRSP rollover described above, there are other ways in which payments for wrongful dismissal can become at least partially tax-free.

(A) If you sue your employer for an injury such as **mental distress** or for **defamation** (libel or slander), and the settlement or Court award explicitly allocates some amount to these kinds of damage, that amount can be non-taxable.

If you take this approach, you need to be prepared to live with some uncertainty for several years. There is always a good chance that your situation will not even be audited, let alone reassessed. Once three years have passed from the date of your Notice of Assessment for the year in which you receive the payment, the CRA normally cannot reassess you.

(B) Similarly, the CRA normally accepts that if you and your employer classify part of the award as damages for a **human rights violation**, then that portion will be tax-free (up to the maximum that could be awarded under the applicable human rights legislation).

(C) Along the same lines as above, it may be possible, in cases of severe wrongdoing by your employer, to have a Court classify part of your award as **"punitive damages"** or "exemplary damages", which would be non-taxable.

(D) You can ask your employer to provide you with re-employment or retirement **counselling services** as part of the settlement. These are non-taxable benefits under the Income Tax Act.

(E) Amounts paid by the employer to your lawyer to cover your **legal expenses** are not taxable to you. Similarly, if you receive the funds and pay your lawyer yourself, the legal fees are deductible against the settlement, and so can reduce the "retiring allowance" or employment income on which you must pay tax.

Because of all the tax angles, it is crucial to **do tax planning very early on in the process of making a claim for wrongful dismissal** – right from the first letter you or your lawyer write to the employer.

AROUND THE COURTS

"House hopper" loses out

Wall v. The Queen (2019 TCC 168) is a recent case of a so-called "house hopper" who repeatedly built and sold new homes, purporting to move into each one as his principal residence. He was assessed for both income tax and GST, and he lost his appeal to the Tax Court.

Wall was a real estate agent and developer in Vancouver. He sold homes in 2006, 2008 and 2010, for a total of $5.8 million (and apparent profit of $2.2 million) without reporting the profits as income and without remitting any GST. Wall took the position that each home was his principal residence and therefore the principal-residence exemption applied.

Wall was assessed for income tax on his profits of $2.2 million, plus gross negligence penalties. (The $2.2 million was after expenses for which the CRA generously gave him credit based on estimated construction costs; he had not kept any records or invoices.) He was also assessed for GST not remitted out of each home sale. As well, he was assessed for income tax and GST on the sale of a vacant lot. The total GST assessment, including interest and failure-to-file penalties, was almost $600,000. He appealed the assessments to the Tax Court of Canada.

The Tax Court judge allowed the appeal only in two respects, both as conceded by the CRA at trial. First, Wall's gain on the vacant lot was a half-taxed capital gain rather than business profit; Wall had co-purchased the lot with his wife in 1992, and became sole owner in 1998 after they separated. Second, the CRA had inadvertently added $160,000 to Wall's income by assessing an amount in the wrong year, so this was reversed. In other respects the assessments were upheld.

Wall claimed that he built each of the three homes with the intention of living there, and sold each one only due to a change of circumstances and mounting debts. However, the judge did not find Wall credible, especially since he could not have financed any of the homes on his reported income, and he had a long history of developing and selling properties. Furthermore, Wall did not earn any real estate commissions during the years in question, other than from a few sales for himself and family members; it was clear that he devoted all his work time to the building and resale of these homes.

The judge reviewed Wall's testimony in detail and found it riddled with inconsistencies, contradicted by other evidence, and simply not credible on many points. The Court did not believe that Wall actually lived in any of the homes, as there was no reliable evidence of this.

The income tax gross-negligence penalties were also upheld, since he "knowingly determined that he would not report his income from the sale of the three homes on the basis that he would claim the principal residence exemption". He knowingly made "blatant" false statements, and the penalty applied. The same facts justified the late reassessments, which otherwise would have been statute-barred.

On the GST side, it was clear that Wall was a "builder" as defined in the legislation. He had not built the homes purely for personal occupancy. As a result, the sale was taxable and all penalties were upheld.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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