Tax and estate planning in uncertain times

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Jamie Golombek, Debbie Pearl-Weinberg and Tess Francis
Tax and Estate Planning, CIBC Private Wealth

The past few years have held much financial uncertainty for both individuals and businesses. This report will review some of the planning opportunities that may be available during these uncertain times.

Tax-loss selling

Tax-loss selling involves selling investments with accrued losses to offset capital gains realized elsewhere in your portfolio. Any net capital losses that cannot be used currently may either be carried back three years or carried forward indefinitely to offset net capital gains in other years.

Superficial losses

If you plan to repurchase a security you sold at a loss, beware of the "superficial loss" rules that apply when you sell property for a loss and buy it back within 30 days before or after the sale date. The rules apply if property is repurchased within 30 days and is still held on the 30th day by you or an "affiliated person," including your spouse or partner[1], a corporation controlled by you or your spouse (or partner), or a trust of which you or your spouse (or partner) are a majority-interest beneficiary (such as your RRSP or TFSA). Under the superficial loss rules, your capital loss will be denied and added to the adjusted cost base (tax cost) of the repurchased security. That means any benefit of the capital loss could only be obtained when the repurchased security is ultimately sold.

While it may be tempting to transfer an investment with an accrued loss to your RRSP or TFSA to realize the loss without actually disposing of the investment, such a loss is specifically denied under our tax rules. There are also harsh penalties for "swapping" an investment from a non-registered account to a registered account for cash or other consideration. To avoid these problems, consider selling the investment with the accrued loss and, if you have the contribution room, contributing the cash from the sale into your RRSP or TFSA. If you want, your RRSP or TFSA can then "buy back" the investment after the 30-day superficial loss period.

Foreign exchange considerations – an example

There are times that movements in foreign exchange rates can turn what you think is a loss, into a gain. For example, let's say Jake bought 1,000 shares of a US company in November 2012 when the price was US$10 per share and the US dollar was at par with the Canadian dollar. In July 2023, the price of the shares has fallen to US$9, and Jake decides he wants to do some tax loss harvesting, to use the US$1,000 [(US$10 minus US$9) times 1,000] accrued capital loss against gains he realized back in January 2023.

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[1] In this article, spouse refers to someone to whom you are legally married. Partner refers to a common-law partner under the *Income Tax Act*, which means someone who cohabits with you in a conjugal relationship, provided the two of you have cohabited for the past 12 months or are jointly parents of a child.

To determine whether the strategy will work, he'll need to convert the potential US dollar proceeds back into Canadian dollars. If the exchange rate in July 2023 was US$1 = CA$1.33, selling the US shares for US$9,000 yields CA$12,000. So, what initially appeared to be an accrued capital loss of US$1,000 turns out to be a capital gain of CA$2,000 (CA$12,000 minus CA$10,000) for Canadian tax purposes. If Jake had gone ahead and sold the US stock, he would actually be doing the opposite of tax loss selling and accelerating his tax bill by crystallizing the accrued capital gain in 2023.

Gifting property

If you wish to gift assets to family members, gifting when asset values are lower may result in a reduced capital gain (or increased capital loss) in your hands. When you gift property, the tax treatment is the same as if you sold the property at its fair market value (FMV). The difference between the FMV and your adjusted cost base (ACB) or tax cost of the assets will be a capital gain (or loss). Capital losses may be used to offset your capital gains and you'll pay tax on 50% of any net capital gains. Net capital losses may be carried back three years or forward to the future to offset net capital gains of other years. The family members receiving the property from you will have an ACB equal to the FMV at the time of the transfer, with any future change in value taxed in their hands.

Prior to gifting any assets, you should be comfortable that you won't need those assets to cover expenses during your lifetime. You should also take into account that you will lose control of any property that is transferred to others. For instance, if you transfer ownership of a family cottage to your adult children, you generally won't be able to use that cottage without your children's consent!

Incorporated business owners

Tax-free dividends

If your corporation has unrealized losses in its investment portfolio, before triggering any such losses, it's worth checking to see if there is a positive balance in your corporation's capital dividend account (CDA). The CDA is a notional account that tracks the non-taxable portion of capital gains, among other things. Dividends may be designated as capital dividends, which are generally tax-free to the shareholder, if they do not exceed the balance of the CDA. Net capital losses will decrease the CDA and will, therefore, reduce (or possibly even eliminate) the capital dividends that may be paid. Prior to realizing any capital losses, consider paying out any capital dividends to the extent that there is a positive balance in the CDA.

Loss consolidation

You may have more than one corporation held within a corporate group. One (or more) of these companies may be profitable ("Profitco"), and one (or more) may be suffering losses ("Lossco") at this time. The Canada Revenue Agency (CRA) has generally permitted the consolidation of losses within a related group through a variety of methods. For example, Profitco may subscribe for shares of Lossco, which in turn makes a loan to Profitco. Interest payments on the loan will reduce the taxable income of Profitco, and the taxable interest income received by Lossco will be offset by its losses.

As corporate reorganizations are complex, tax and legal advisors should be consulted before implementing any loss consolidation transactions.

Business transition planning

You may be thinking about transitioning your business to new owners. If you believe that the value of your business has recently dropped in value, now may be a good time to consider various planning options.

Gift of shares

One of the common transition plans for a family business is to transfer it to the next generation. Your first inclination may be to simply gift the shares of your business in equal portions to all your children, or perhaps, only to the children involved in the business. Of course, you would only contemplate doing this if you don't need the money from the potential sale of the shares to fund your personal lifestyle and retirement.

As discussed above, making a gift has income tax consequences. Just as with any gift, if you believe the current value of your business is lower than it was in the recent past, now may be a good time to consider making a gift of shares to family members. Any capital gain realized on the gift of shares will be lower if the value of the business has fallen, and future growth will be taxed in the hands of the family member receiving the shares.

Sale of shares

In most family transition plans, rather than an outright gift of the shares, it is more likely that the business will be sold to the next generation since the proceeds from the sale represent a lifetime of wealth accumulation for the owner manager, who generally needs those funds to live on after retiring from the business. If the value of your business has dropped recently, and you are comfortable retiring on the proceeds received from a sale at this lower value, this may be an opportune time to sell to family members. If you are tempted to sell the shares to family members at a price less than their FMV, double taxation may arise, as you will still be treated as if you received proceeds equal to the FMV. But, for the family members who receive the shares, their new ACB will be limited to the price they paid.

Estate freeze and refreeze

An estate freeze is a corporate transaction that allows you to essentially "freeze" the value of your ownership in the corporation and have the future growth in the value of the company accrue to someone else, such as your children, who will ultimately control the business. The result is that your tax liability can be fixed at today's FMV and the tax liability on any future growth can be transferred to the new owners (such as family members.). A freeze can generally be done on a tax-deferred basis, leaving your tax bill to a later date.[2]

Doing a freeze when your company's value is lower can permit you to reduce the taxes that arise on your death, assuming the value of the shares appreciates over the remainder of your lifetime. You must, however, ensure that the value associated with your freeze shares today will be sufficient to support your future needs.

But what if you've already implemented an estate freeze when your company's value was higher? In this case, you may wish to consider a "refreeze." For example, if you froze the company when its value was $5 million, and today the company's value has dropped by 20% to $4 million, you could refreeze by exchanging your old, preferred shares redeemable at $5 million for new preferred shares redeemable at $4 million (assuming you are comfortable with this reduced entitlement.) Note that a shareholder benefit may arise with a refreeze, so care should be taken with this strategy. Should market conditions recover and the business go back up in value, any future gain can be taxed in the common shareholders' hands instead of yours (or, ultimately, your estate's.)

The lifetime capital gains exemption

The lifetime capital gains exemption (LCGE) may be available to shelter up to $971,190[3] (2023 amount) of capital gains on the disposition of qualified small business corporation (QSBC) shares. This includes gains realized on the sales and gifts of shares, as well as estate freezes, which may allow families to multiply the use of the LCGE.[4]

Simply stated, QSBC shares are shares of a Canadian-controlled private corporation (CCPC) in which "all or substantially all" (interpreted to mean 90% or more) of the value of the corporation's assets is used in an active business in Canada at the date of sale or transfer. In addition, either you or someone related to you must have owned the shares for at least two years prior to their disposition and, during that entire two-year period, more than 50% of the corporation's assets must have been used in an active business in Canada.

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[2] Note that the tax on split income (TOSI) rules may so professional tax advice is critical when planning an estate freeze.

[3] The LCGE is $1 million for qualified farm or fishing property, including shares of a family-farm or fishing corporation in 2023.

[4] Note that the tax on split income (TOSI) rules may so professional tax advice is critical when planning an estate freeze.

To meet this test, owners often “purify” their CCPC in advance of a disposition of the shares, to remove passive assets that could put the corporation offside of the active business tests. There are a number of ways to do this, including removing investments from the corporation. This may be an opportune time for such purification measures if the investments in the corporation have dropped in value. This strategy could be useful even if you are not considering the disposition of your business in the short term.

Estate planning

During uncertain times, it's prudent to ensure that your estate planning is up to date. Estate planning is the process of making arrangements for the management and eventual transfer of your property according to your wishes. It's particularly important to make sure that family members, especially those tasked with carrying out your wishes, are aware of your plans, as well as the location of your essential estate planning documents and information. Many professionals are now available for telephone and online virtual meetings to assist you remotely with your estate planning needs. While estate planning can include the use of insurance, trusts and tax planning, depending on the complexity of your estate, all plans should include a will and powers of attorney[5].

Wills

A will is at the heart of every good estate plan. This key document records your intentions for the management and transfer of estate assets. If you don’t have a will, you are giving up your right to have a say in the following matters:

- Who will manage your estate
- Who will inherit your estate assets
- When will estate assets be distributed
- What steps could be taken to minimize estate taxes.

Powers of attorney

There are two types of powers of attorney. A power of attorney for property gives someone else the legal ability to deal with your financial affairs based on its terms. It may become effective immediately and may continue to be valid in the event of your incapacity; alternatively, you could stipulate that it only becomes operative if you are incapacitated.[6]

A power of attorney for personal care[7] authorizes someone to make personal, health and medical decisions on your behalf in case of your incapacity.

Now may be a good time to ensure that your powers of attorney are properly prepared and up to date.

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5 Representation agreements or mandates may replace powers of attorney in some provinces.

6 In Québec, a mandate of protection (in case of incapacity) becomes effective upon the occurrence of incapacity and homologation by the court.

7 In Quebec, a power of attorney is also called a mandate and the attorney is called the “mandatary”.

Tax and estate planning using inter vivos trusts

While many people think about transferring property upon death, you may also wish to consider transferring property during your lifetime. A trust can be a useful tool in this process. Transferring assets into a trust can offer a number of benefits over direct gifts including:

- Control over the timing and amount of distributions to beneficiaries, which may be particularly useful for spendthrift or incapacitated beneficiaries, who may not have the responsibility or capacity to manage funds themselves.
- Flexibility in structuring payments to beneficiaries to allow for changes in the amount and timing of distributions, or perhaps even for changes in the choice of beneficiaries, based on future circumstances.
- Lower tax bills for the family, which may be achieved through income splitting or charitable gift planning.
- Reduced probate fees in certain jurisdictions, since assets placed into some types of trusts pass outside the estate.
- Maintaining privacy for your estate since, unlike a will, a trust agreement is not subject to a public probate process.
- Reducing income that you realize from assets. When you transfer property to a trust, the tax treatment is the same as if you sold the property at its FMV and you may have a capital gain (or loss).[8] Transferring assets when values have dropped may decrease your capital gain (or increase your capital loss.) The trust (or its beneficiaries) will generally pay tax on income earned in the future on the trust assets.[9]

Be sure to speak to tax and legal professionals prior to establishing a trust to see if this strategy makes sense as part of your estate plan.

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Private Wealth in Toronto.

jamie.golombek@cibc.com

Debbie Pearl-Weinberg, LLB is the Executive Director, Tax & Estate Planning with CIBC Private Wealth in Toronto.

debbie.pearl-weinberg@cibc.com

Tess Francis, CFP, CPA, CA, CPA/PFS, TEP is the Director, Tax & Estate Planning with CIBC Private Wealth in Toronto.

tess.francis@cibc.com

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8 Exceptions apply for transfers to certain trusts.

9 In some circumstances, you may still pay tax on the future income under the attribution rules.