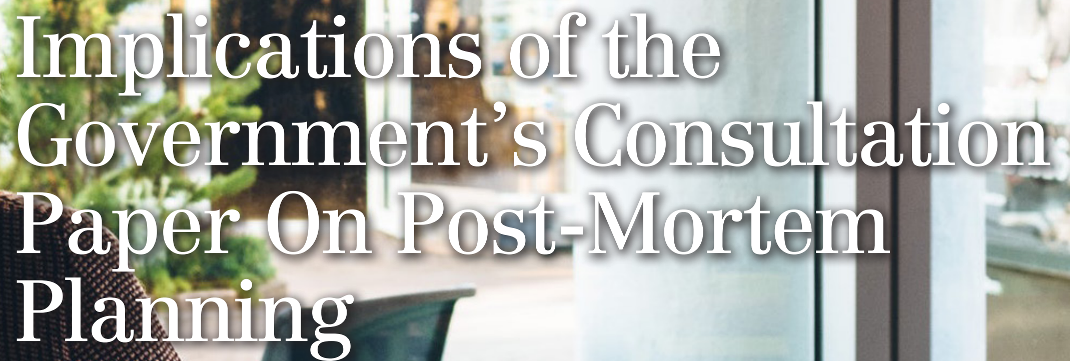

Implications of the Government's Consultation Paper On Post-Mortem Planning

CANACCORD Genuity
Wealth Management

Dan Kostenchuk, Partner, Canadian Tax at BDO Canada, LLP

Changes proposed in the federal government's recent consultation paper, "Tax Planning Using Private Corporations", could have significant impacts to post-mortem planning for business owners, both in the future and for in-progress estates. The changes are designed to close loopholes and address perceived issues of fairness in three main areas:

1. Income splitting with family members to reduce the total family tax burden.

2. Passive investment portfolios owned by private corporations.

3. Strategies that convert regular or dividend income into capital gains.

While all areas could impact business owners, the third area could have some significant consequences for post-mortem planning.

Post-mortem strategies

When an individual dies, they have a deemed disposition — essentially a sale — of any assets, and the gain or loss on the disposition of these assets is reported on the individual's final tax return. If the individual owns shares of a private company, they are deemed to have sold those shares upon death, resulting in a capital gain. If the beneficiaries of the estate then wish to draw assets from the company, the estate incurs a dividend on that money. Without further planning, this process would result in paying double tax: once on the final tax return, and again on the estate's dividend.

Under current tax law, there are two methods used to address this situation and avoid double taxation:

1. **164(6) loss carryback.** Using this strategy, the estate pays dividend tax rates (generally 30-43 percent, depending on province) and the tax that was previously paid on the capital gain on death is eliminated. For loss carryback planning to work, the estate must liquidate all company assets within one year of the owner's death.

2. **Pipeline planning.** Under this method, rather than dividend tax rates, the estate pays capital gains tax rates, and the tax paid on the capital gain on death is removed. As capital gains tax rates generally range between 22-27 percent, depending on province, this method can provide a significant tax advantage, especially for larger estates.

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The government's proposed changes eliminate the pipeline planning method. Estates will no longer have the option of paying capital gains rates, and must pay dividend rates to liquidate the assets of a company. This change, if implemented as proposed, will have a number of serious consequences on post-mortem planning and estates.

Impacts of the proposed changes

For a loss carryback strategy to work the estate must liquidate company assets within one year. Currently, if the assets are not liquidated within that timeframe, the only options are to initiate pipeline planning or to pay double tax. With these new changes, in addition to the increase in overall taxation that will result from the estate paying dividend rather than capital gains tax rates, there will now be an increased pressure to wrap up the estate within a limited time period with no fallback plan. Should the estate fail to liquidate assets within one year of death, double taxation will likely occur.

If these changes are implemented as currently written, they will take effect as of the date of the release of the consultation paper: July 18, 2017. This means that in addition to affecting estate planning moving forward, the changes will also apply to any in-progress estates. These rules, if applied to in-progress estates as written, would result in a range of potentially significant financial issues.

For example, any estate still in the process of liquidating business assets for a business owner that died more than one year before July 18, 2017 will face double taxation with no recourse. In another scenario, an estate could have already made an interim distribution of assets on the assumption of capital gains tax rates applying, and will now be faced with dividend tax rates, resulting in insufficient funds remaining to pay taxes owed.

One possible solution would be for the government to only apply the proposed changes to deaths occurring after the implementation of the new rules, rather than to all open estates. However, no such modifications to the proposal have yet been made.

Post-mortem planning considerations

In light of the proposed changes, business owners should start to:

1. **Review current wills.** When creating a will, many individuals will allocate amounts to be given to family members, charities, and others with an assumption that a certain amount of their total assets are going to be given in tax. As the rate of taxation for many could increase by approximately 50 percent if the proposed changes go through, there might not be enough money left over after tax to make all of the anticipated distributions. Business owners are strongly encouraged to go over estate plans, including life insurance amounts, to calculate the amount that will remain after dividend taxes to ensure that there will be sufficient funds for the distributions in your will.
2. **Evaluate whether to draw out funds prior to death.** Under the old rules, as someone neared the end of their life they would generally leave funds within the company, knowing that lower capital gains rates would apply upon death. Under the new rules, there are situations in which it may make more sense to draw out funds while the individual is alive, as dividend tax rates will apply regardless. The incentive to keep money within the corporation is essentially gone, which means that revisiting compensation plans may be in order.
3. **Reconsider funds held in companies.** Many business owners use private companies as a form of personal RRSP, with the corporation holding investments as a retirement fund. These individuals, not just high-income business owners, will be affected by these changes, as well as other changes proposed in the consultation paper. Business owners who have been moving forward with company-held retirement funds are strongly recommended to speak to their tax advisor.

Note that no action should be taken until the government announces whether any changes will be made to the proposals. This announcement is expected before the end of 2017.

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